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2020 FORECAST

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As we have done for the past eleven years, the Retail and Commercial Development Group of Cox, Castle & Nicholson LLP has, once again, taken on the daunting task of forecasting what to expect in the forthcoming year in four critical segments that affect the retail and office industries. In doing so, we analyzed the social, political and economic events of 2019, reviewed various economic data and projections and have come to certain opinions relating to the retail and office industries and where they are heading in 2020. Included here is the product of our thinking, in the form of four articles of interest addressing such topics as capital markets, retailing, retail development, and office leasing.

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CAPITAL FOR RETAIL IN 2020 – THE ECONOMIC EXPANSION CONTINUES FOR AN UNPRECEDENTED DURATION

by Gary Glick

The 2019 recession predicted by many economists never materialized. When an economic slowdown appeared imminent in the first quarter of 2019, in part due to President Trump's tariff war with China, the scarcity of housing, the looming Brexit crisis, the ballooning national debt and rising interest rates, the Federal Reserve stepped in and lowered the federal discount rate twice over a short period of time. The rate cuts, along with the easing of the tariff war with China, helped rally the economy in the second half of 2019, diminishing further talk of a recession. The U.S. is now experiencing the longest economic expansion in its history (approximately 10 years), as well as record highs in the stock market, a strong GDP, low unemployment, low inflation and historically low interest rates.

However, the economy is not without warning signs. The U.S. deficit is now the largest in history, and a housing shortage continues to exist (including a significant price gap between wages and the affordability of housing in much of the country). In addition, yields on 2-year treasuries are higher than yields on 10-year treasuries (a so-called "inverted yield curve"), which historically presages a recession. Despite these warnings signs, many experts expect that the economy in 2020 will be reasonably comparable to 2019, though such expectations are subject to a long list of uncertainties, including election year issues (e.g., very expensive economic proposals from some of the leading Democratic presidential candidates).

As has been the case for a number of years, the retail real estate sector is going through a significant transformative period that has made it a less than favorable class for capital investment in 2019, as compared to the industrial, multi-family and office real estate sectors. However, despite the numerous retail store closures and/or bankruptcies in 2019, retail developers and retailers have been adapting to a changing landscape where e-commerce continues to attract a larger share of dollars each year. Taking the place of many of the retailers that are not expanding or that have gone bankrupt are retailers in the food, fitness and wellness fields. In addition, despite the fact that apparel retailers have been significantly impacted by e-commerce, discount apparel stores such as Ross and Marshalls continue to thrive, along with many high-end retailers. Many retailers have continued to expand, including Target, Burlington, Ulta, Amazon, Whole Foods and Aldi.

Grocery-anchored shopping centers, regional malls in “A” locations and in-fill, lifestyle centers are all still considered a favored class by investors. Although investment sales were down slightly in 2019 from 2018, sales were still significant, especially in the second half of 2019 when interest rates were at historic lows. For grocery-anchored shopping centers in well-located areas, cap rates remained in the 5% range, maybe a slight increase from 2018. However, single-tenant leased properties with strong performing credit tenants like Chick-fil-A, In-N-Out and McDonald’s continue to trade at cap rates in the 3% to 4% range. Shopping centers in B locations or with tenant mixes very susceptible to e-commerce competition were selling (if at all) at cap rates closer to 7% or 8%.

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It is our expectation that investment sales will continue to remain strong again in 2020, subject to the same or similar cap rate parameters as those described above. Unless inflation becomes an issue, which has not been the case for the duration of the current economic expansion, most economists do not believe that the 10-year treasury rate will be much above 2.5% in 2020. In addition, with a softening of the economies of numerous European countries, foreign capital is expected to continue to flow into real estate developments in the United States. Furthermore, 2019 saw a reduction in capital investment from China, largely due to the trade war with the United States and policies in China constraining investment by Chinese nationals in the U.S. If the trade war ends or substantially diminishes in early 2020, there could be a significant outflow of capital from China into U.S. real estate.

Debt and equity for retail development in 2019 remained very comparable to 2018. Significant capital remained available from banks, life insurance companies, REITs, debt funds, equity funds and CMBS lenders.

Lenders continued to remain disciplined in 2019 with respect to the retail sector, although loan-to-value ratios in some instances increased. The Great Recession taught the lending industry some hard lessons, and lenders and regulators are not likely to allow a repeat of the same lax credit analysis and exuberant projections seen in loan underwriting in the mid-2000s. Among potential lenders, banks are probably most constrained by regulatory

requirements. However, they still originated a significant number of loans in 2019, mostly construction loans and floating rate loans tied to LIBOR, and almost always portfolio loans.

Life insurance companies also continued to lend in 2019 at a comparable pace to 2018. These loans were usually permanent loans with terms of 10 to 20 years, at fixed rates in the 3.5 to 4.5 percent range, usually with a straight line amortization over 30 years. The mortgage portfolio of life insurers grew by about 5 percent from 2018 to 2019. As in past years, life companies continue to remain conservative in their underwriting policies and deal structuring. Like banks, life insurance companies continue to be impacted by competitive pressures from other debt sources.

In addition to permanent loans, life insurance companies also provided a significant amount of construction and mezzanine lending in 2019, continuing a trend from the past few years. However, the vast majority of this lending was linked to permanent mortgages that remain the primary debt vehicle for life companies. Because of the smaller share of riskier debt on their books, life companies are likely to be less affected by a mild recession as compared to other capital providers.

As was the case in 2018, private equity debt funds continued to proliferate. According to the research firm Preqin, private equity real estate debt funds raised more than $165 billion since 2013. It stands to reason that these fund have proliferated: capital cannot be deployed in the bond markets with the expectation of any significant returns in light of the low interest rate environment, and many investors are wary of investing in what many believe to be a bloated equities market. Fewer private equity real estate debt funds were deployed in 2019 than in 2018, largely due to the lack of new retail construction or existing projects that made economic sense.

CMBS lending increased slightly in 2019 based upon the incredibly low interest rate environment. The 10-year treasury fell to a year-to-date low of 1.47% in the third quarter of 2019, levels not seen since 2016. CMBS volume in 2019 was in the range of $90 billion, which easily exceeded the full-year 2018 level of $75 billion. Looking ahead, some observers believe that 2020 CMBS volume could rise to about $95 billion.

There was no shortage of equity capital available in 2019, but providers of equity had trouble finding retail deals that made economic sense. For the right deal, equity was plentiful. However, many providers of equity were more inclined to provide these funds to more favored asset classes, like industrial and multi-family. We expect this same trend to continue in 2020.

In summary, we expect that capital markets in 2020 likely will be very similar to 2019. For retail developers, the key to accessing this capital is to have the right product type. As was the case in 2019, grocery-anchored shopping centers (with a well performing grocer), regional malls in “A” locations and in-fill, lifestyle centers in gateway cities will attract the most capital (both debt and equity). However, other retail projects will also attract capital, just at a higher cost and/or with the requirement for more equity. All of this could change if political and economic factors change, especially if the 2020 elections result in a major political change in Washington.

Scott's practice focuses on retail development and commercial leasing. He has a comprehensive experience in representing commercial developers in connection with all aspects of shopping center development, including the acquisition and disposition of commercial real estate and the negotiation and drafting of development and management agreements, reciprocal easement agreements, declarations, major tenant leases, listing agreements, and property management agreements.

WILL RETAIL KEEP ROLLING INTO 2020?

by Scott Grossfeld

Last year (2019) was similar to recent years for the retail sector, in that retail remained a reasonable, well-performing, stable and mildly growing class, facing a few curveballs to navigate over the course of the year. However, all in all, core fundamentals appeared to remain strong and well rooted. Despite this, various factors persisted during the year that could not help but make one feel that the economy, and retail in particular, had a potential of falling back into recession. Uncertainty resulted from volatility in the stock markets early in the year, trade disputes and tariffs, international trade issues and Brexit, international political disputes, turmoil abroad and at home (including impeachment issues), and various other factors. The question is whether, and how long, the retail market will be able to stave off the impact of these influences into the future.

The good news looking forward is that the foundations and fundamentals still look strong. Heading into 2020 the stock markets are at all-time highs, consistently setting new records. Unemployment is at record lows. Wages are increasing, interest rates are low and capital is plentiful. At its most recent meeting, the Federal Reserve Board announced that it would not increase the federal rate for borrowing funds and that it was not likely to increase the rate for the immediate future. Consumer confidence is at reasonably high levels. And, the Administration announced a Phase 1 deal with China on trade to be signed in mid-January.

The foregoing factors point in a very positive direction for the availability of capital for the continuation of retail development and productivity and the availability

of disposable funds for goods to sustain consumer activity. So long as these fundamentals remain strong, the prognosis for retail should remain good.

It was noted in a recent *Orion Investment Real Estate* article that "[a]s of December, the U.S. economy has expanded for a record 126 straight months, the longest time period in the country's history according to the National Bureau of Economic Research. Put another way, the U.S. has avoided a recession for an entire calendar decade for the first time ever." However, some fear that the recovery from the Great Recession has been longer than should be expected and that the current Presidential Administration's policies as to the economy are overly random and arbitrary. For these and other reasons, the economy and retail may begin to slip from their positions of growth and have commentators wondering *"if and when the other shoe may fall."*

Holiday Sales and Other Indicators of Growth

As we have reported over the years, recent performance of the economy and holiday sales are often good indicators of upcoming retail industry performance in the ensuing year. Based on projections from retail industry analysts and other data, the general U.S. economy at the end of 2019 and the 2019 holiday sales period appear to have performed exceptionally well and are harbingers of good things to come in 2020 for the retail industry.

Based on a recent *Wall Street Journal* article, U.S. retail sales rose 0.3 percent in October 2019 from the previous month and sales in the first 10 months of the year were up 3.1 percent over the same period in 2018. In addition, according to a recent *AP* article, the National Retail Federation forecasted an increase in retail sales during the holiday sales period of between 3.8 percent and 4.2 percent as compared to 2018.

Recent publications of the *International Council of Shopping Centers (ICSC)*, including in its *Industry Insights* and *ICSC.com News* publications, projected that "[n]o fewer than 90 percent of holiday shoppers plan[ned] to shop in stores [during the 2019 Black Friday weekend], and that rises to 97 percent when purchases made online from retailers with stores are included."

It was noted in ICSC's research that "despite growth in online shopping – much of which is actually a result of traditional brick-and-mortar retailers' expanding their online capabilities – physical stores remain the indispensable foundation of the consumer landscape. The importance of these venues is even greater this year, given a solid rise in the amount of shoppers planning to use click-and-collect." Click-and-collect shopping is the practice "by which customers buy online and pick up their goods in stores, [which ICSC found] will be popular, with 44 percent of holiday weekend shoppers saying they'll be shopping this way compared to 40 percent in 2018. Of this year's click-and-collect shoppers, nearly three quarters say they expect to make an additional purchase when picking up their merchandise."

It is apparent that brick-and-mortar retailers are continuing to learn, evolve and become increasingly flexible in response to the growth of e-commerce. This has resulted in the growth of omni-channel resources and retailing. Retailers that have better adapted to e-commerce options in their businesses have been most able to survive and move forward in the internet retail economy.

Concerns in 2020

As with the past few years, despite the positive economic figures, nagging issues and concerns continue to exist that could impact the retail sector going forward.

Many commentators remain concerned about the ongoing uncertainties stemming from the U.S. trade war with China and related tariff battles. These disputes could easily affect the delicate balance of the economy. It is true that a Phase 1 deal appears to be on the horizon, but if history is any indication, it would not be a surprise if an agreement is ultimately dishonored or later negotiations go awry, with potential negative effects on the economy.

In addition, Brexit should finally occur in 2020. This will likely have a significant impact on the global economy, but how it may impact the U.S. will remain to be seen.

Last year surpassed 2017 in store closings. Store closures of significance included locations for Sears, JC Penney, Bed, Bath & Beyond, CVS and Forever 21, to name a few. Whether major closings will continue into 2020 and how the excess space from such closings would be absorbed is unknown. However, to the extent retail is able to remain reasonably robust, the retail sector should be able to adapt.

Trends

As e-commerce has grown over recent years, brick-and-mortar retail has adapted, evolved and changed. These changes have mostly occurred (and will continue to occur) as a result of e-commerce forcing brick-and-mortar uses that are more popular online to operate exceedingly less (if at all) in physical stores. In contrast, a more recent phenomenon, is that traditional online retailers are starting to operate physical store locations.

According to the *2020 Emerging Trends in Real Estate* published by PwC and ULI, "[a] new crop of retailers have recognized the importance of physical stores and they are slowly building out a brick-and-mortar footprint…. [O]nline brands are expanding further into brick-and-mortar spaces while legacy brands waver." An example of this is the entry of various Amazon concepts into the retail marketplace.

As many commentators have noted for years, retail has been moving towards a more experiential and entertainment-focused dynamic – something that cannot be duplicated by the internet and e-commerce. As stated in *2020 Emerging Trends in Real Estate*, "[n]ew experiential and entertainment uses, centered on one-of-a-kind activities, such as art, amusements, or food, are continuing to push the boundaries of what is supportable in shopping centers…. [T]he share of space devoted to restaurants, fitness centers, and entertainment has doubled over the past 10 years, while the share of apparel space continues to decline." Despite this trend, significant apparel-heavy, value retailers, such as Ross, TJ Maxx and Marshalls continue to perform well.

Food and beverage uses are increasing in popularity and number. Food halls in some markets are becoming very popular. Fitness, health and wellness uses in all forms, including high-end, big box, boutique and value, continue to expand. Co-working and shared office spaces are also attracting interest from shopping center developers, particularly in malls with spaces vacated by department stores and similar large users.

* * *

Consistent core fundamentals continue to keep the retail sector alive, well and a viable force to be reckoned with into 2020. Outside forces continue to be concerns that need to be monitored and may impact the health and well-being of the sector. However, so long as unemployment and interest rates remain low and capital investment remains available, retail should continue to expand with the remainder of the economy.

RETAIL DEVELOPMENT – HOLDING ITS COURSE

by Daniel Villalpando

Dan's practice focuses on retail development and commercial leasing. Commercial developers on the West Coast look to Dan for his counsel on all aspects of shopping center development, including the acquisition and disposition of commercial real estate and the negotiation and drafting of development agreements, reciprocal easement agreements, declarations, and major tenant leases.

As calendar year 2019 approached, many in the retail development industry felt a sense of tempered optimism, and those feelings appear to have borne out. Statistically, 2019 turned out to be a good year for retail developers (and retailers), with estimates that core retail sales (exclusive of gasoline and automobiles) in 2019 rose approximately 3.3% over sales in 2018. This increase continues the recent trend of modest to good growth in retail sales, and begs the question: Can we expect to see even more improvement in 2020? Based on positive news regarding the gross domestic product, continued growth in the job sector and advancements in the meshing of online and brick-and-mortar retail, it appears that there may be reason to expect that retail development will continue with another modest uptick this coming year.

One facet of the economy that has a major influence on the health of retail development is the gross domestic product (GDP). The weak growth rates in the GDP of 2009–16 (which stagnated below 2% annual growth) look like they may be behind us, as statistics indicate growth of 2.5% in 2019. In addition, retail sales increased 4.1% in September of 2019 over the same month in 2018, exceeding market expectations. Moreover, all signs point to robust consumer spending this past holiday season (with some analysts expecting a 4% increase in November and December sales compared to 2018) that could further strengthen the 2019 numbers for retailers.

Although housing starts continue to be lower than hoped by homebuilders, the unemployment rate continues to fall, infusing cash into the pockets of many households. According to Moody's, the unemployment rate in 2019 decreased to 3.5% at the end of 2019 (down from 3.9% at the end of 2018), with expectations that it may fall even lower by the time 2020 comes to a close. In addition, most economic forecasts predict continued wage growth into 2020. This news indicates that more people should have jobs, and those jobs should, on average, pay more in the coming year. This should provide a boost to consumer spending, a major influence in retail development.

While there are some positive signs, there remain potential risks to the U.S. economy in general and, by extension, to the retail industry. The Federal Reserve finally bumped up interest rates in the middle of 2019, and further increases may occur. It remains to be seen whether such increases will cause businesses (both developers and retailers) to pull back, or put any proposed expansion on hold. In addition, the impending presidential election, concern over a potentially unsustainable rise in the stock market, and continued uncertainty in the global geopolitical environment could all have a negative impact on the U.S. economy. Moreover, Americans find themselves in historic amounts of debt. For example, credit card debt has surpassed $1 trillion, representing a new historic high. Rather than continue to amass debt, consumers may elect to slow down spending, which could put a drain on the economy. However, these issues remain somewhat speculative in nature, and, at the current time, serve more as something for businesses to note, rather than to address imminently.

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In terms of what is occurring with different types of retail projects, reports of the demise of the traditional regional mall appear to have been at least slightly exaggerated, although the strongest performing regional malls still tend to be located in more affluent trade areas. Overall, owners of regional malls have had to adapt to stay relevant. For example, as the public's shopping habits and practices continue to change, retail developers are learning that "Experiential Retail" is becoming a critical component of a viable shopping center. Experiential Retail places an emphasis on food, fun and fitness in an effort to not only attract customers in the first place, but also to get them to increase "dwell time," or the period they stay at the retail project—with the hope that those customers will spend more money. Experiential Retail is seen as a sector that competes effectively with e-commerce, since transactions are more social than a mere exchange of cash for goods.

Grocery-anchored neighborhood centers generally continue to provide a good return for their owners. Indeed, analysts estimate that there were $7.1 billion in transactions involving grocery-anchored centers in the first nine months of 2019, compared to $6.9 billion in the first nine months of 2018. As in 2018, one of the larger growth sectors in retail is specialty grocers, such as Whole Foods, Trader Joe's and Sprouts; another is discount grocers like Walmart Neighborhood Market. Owners of neighborhood centers continue to be able to attract retailers eager to feed off of the foot traffic generated by a tenant mix that typically includes a grocery store and a drug store.

However, the acquisition of Whole Foods by Amazon continues to spark change in the grocery sector, and some experts predict that we may see a shift in 2020 where consumers get more comfortable ordering groceries online. Such comfort in online ordering and delivery may result in fewer trips to the local grocery store and, therefore, less foot traffic in the neighborhood center. For the time being, however, statistics show that less than 3% of the $674 billion of annual U.S. grocery sales is conducted online.

Other retail developers are being more proactive in dealing with existing space by negotiating early lease terminations. These developers are seeking to strategically take back certain spaces prior to the natural expiration of the applicable leases in order to remerchandise with better tenants and higher rents. Some “mid-box” or “junior anchor” tenants like PetSmart and Staples, who are looking to downsize their footprints, may be willing to give space back early, allowing landlords to aggregate enough square footage to attract certain “hot” retailers in an effort to revitalize their shopping centers. For example, so called “fast-fashion” tenants like H&M and Uniqlo are actively growing and scooping up second generation space. Likewise, discount and dollar stores such as Dollar General, Family Dollar, Dollar Tree and Five Below are also in the market for residual space, often in the 5,000- to 10,000-square-foot range. For example, Dollar General, alone, recently announced plans to open 1,000 new stores in 2020, while also remodeling 1,500 stores.

Meanwhile, many retail developers have had to deal with the closures of department stores, such as Sears, Macy’s and JC Penney. The deconstruction of the department stores, or “right-sizing,” is seen by some as the natural progression of retail; those department stores that have elected to stay open have generally reduced product offerings to three primary product categories—apparel, housewares and cosmetics/fragrances. To combat closures, “specialty leasing” is on the rise, with retail developers looking to re-lease large vacant space to concepts not traditionally associated with shopping centers, such as e-sports facilities, escape rooms, laser tag venues, day care centers, painting studios and cooking schools, all in the category of Experiential Retail. Of course, the ability to add such non-traditional tenants must be balanced against the rights of other existing tenants that may have the ability to keep certain uses out of a given project. A non-traditional use may allow a retail developer to temporarily re-lease space and get some rent in return. But adding such uses may upset major or anchor tenants at a project, who may decide to aggressively fight the new uses or to leave the project when their current term expires, rather than renew or exercise available options.

Not surprisingly, in the coming year, retail developers will continue to face the challenges brought about by the meshing of e-commerce and brick-and-mortar retail. Developers are being forced to work more closely with their tenants to ensure that the space provided is not only physically desirable, but also accessible to mobile devices via upgraded in-store Wi-Fi capability, which is almost a necessity in the current climate. In addition, some Developers are being forced to get creative with their parking lots to provide their tenants with the ability to offer buy-online-pick-up-in-store (BOPIS) capabilities, which appears to be a growing trend. Since statistics show that approximately 82% of BOPIS consumers will shop for additional items while picking up their orders, it is no surprise that retailers are interested in offering this service.

When it comes to the world of retail development, the undercurrent of cautious optimism from the beginning of 2019 continues to exist. While ground-up shopping center development may not be the factor it was 15 years ago, a solid uptick in the GDP, continued growth in the job sector and continued improvements in the meshing of online and brick-and-mortar retail bode well for continued improvement for retail developers in 2020, especially those developers actively adjusting to the latest trends and developments in the retail business.

OFFICE LEASING IN 2020: TECH, CO-WORKING AND MEDICAL OFFICE SECTORS DRIVE GROWTH

by Andrew Ouvrier

Andy's practice focuses on the leasing of office, retail and industrial properties, including "green" leasing and cell site leasing, for a wide variety of landlord and tenant clients, including institutional investors and entrepreneurial individuals and entities. He also regularly represents institutional landlords in the ongoing management of office projects and retail shopping centers.

The United States is in a period of unprecedented economic expansion with the current economic cycle being the longest in U.S. history. Despite increased deficit spending, and an anticipated drop in the gross domestic product from 2.5% 2019 to 2.1% in 2020, given the current low unemployment, low inflation and record highs in the stock markets, the signs of continued economic prosperity are present. While not going so far as to say that the U.S. economy was "recession-proof," Goldman Sachs stated in a recent CNBC article that an economic downturn was unlikely over the next few years.

The fundamentals of the U.S. office leasing markets remained strong throughout 2019, and we expect that trend to continue in 2020. One of the vulnerabilities of commercial real estate development and expansion is the cost (and availability) of capital. Since the cost of capital is currently low (and is readily available) and overall confidence in the economy is high, most economic forecasts predict continued, albeit slower, commercial real estate growth in 2020. Construction and development of new office product has been robust in certain areas of the country, meaning large amounts of new office space will be ready for occupancy in 2020, which may cause a slight increase in vacancy rates in certain locations.

The usual expectation is that when the economy is doing well, there will continue to be increased demand for office space. This was true in 2019, and we anticipate that

office space demand will continue to increase in 2020, although at a slightly slower pace than in 2019. While we expect increased leasing activity in all office leasing sectors, including the financial, insurance and legal sectors, we have seen over the last few years that office demand has been shifting away from the more traditional uses and toward more flexible models. Therefore, we anticipate seeing the greatest leasing growth in the following three types of office users: technology companies, co-working and medical office.

Technology Companies

The “tech” sector was the largest single source of demand for office space in the U.S. in 2019, and we expect that trend to continue. In Los Angeles alone, tech companies signed over 1.6 million square feet of office leases in the first three quarters of the year, while co-working firms came in second with 600,000 square feet of space during that time.

One of the interesting changes we’ve seen over the last few years is that the tech sector affects office leasing not only due to the large amounts of office space that tech companies typically require, but also because of how tech companies and their employees use office space. We’re seeing tech companies focus on how people actually work in an office environment. Instead of merely providing an open floor plan or “creative” spaces, tech companies are acknowledging that people’s attitudes regarding work spaces are changing – for example, it was only a few years ago that incorporating sustainability elements into an office environment was considered a plus, but today it’s an expectation. Moreover, in many cases, the office environment doubles not only as a work environment, but also a social environment, and tech firms increasingly look to strike a live/work/play type of balance in their office spaces. Larger tech companies are providing amenities such as cafeterias, fitness centers, access to health professionals, private work spaces for focused work and open environments for communal work and engagement. Tech companies are willing to provide these amenities in an effort to make an office environment more of a community and to attract and retain “talent”. In many cases, it’s no longer enough to have third party amenities located near a building – tech companies are pushing to have third party amenities located within their buildings.

Given these tech company requirements, which go far beyond merely providing square footage, it’s not surprising that certain buildings may be better suited for tech use than others. One trend that’s emerging is an increased demand for buildings with larger floor plates that allow for greater concentrations of communal space on single floors, instead of having that space broken up on multiple floors in buildings with smaller floor plates. As one example, a landlord of a two-tower project in West L.A. recently told an audience at a real estate event that in order to address this need, it has been looking into connecting the floors of one tower to the floors of the other tower with pedestrian bridges in an effort to “expand” the footprint of each floor. We expect that developers and landlords with office space positioned to provide these items to tech companies will have advantages in their leasing activity.

We’re seeing that the tech sector’s demand is highest for new office product, followed by the demand for older buildings that have been substantially renovated. New office products are constructed to higher sustainability standards that are attractive to the workforce, have larger windows and more glass, higher ceilings, and often larger floor plates that can more easily accommodate desired amenities. Given the push for such amenities, there’s a growing concern that developers who aren’t able to substantially renovate older buildings to address at least some of these concerns may begin to face functional obsolescence as workforces move to buildings that are able to provide (or provide the space for) the desired amenities.

But it’s not just the tech sector pushing for more amenities. As these amenities become more commonplace, we anticipate other office use sectors, such as financing, insurance and legal, to follow suit.

Co-working

It has been a busy year for co-working companies. Co-working was a large part of many cities' main leasing activities in 2019: at one point in 2019, new leases with co-working companies accounted for nearly one-third of the office leasing activity in New York City, and WeWork's lease at Wilshire Courtyard was one of the largest office leases in Los Angeles in 2019. This heightened activity during the first three quarters of the year was then followed by WeWork, the largest and most prominent co-working company, pulling its IPO, ousting its CEO, and downsizing many of its non-core operations. Despite this tumble by WeWork, and the ripple effects it will have throughout the industry, we expect the co-working office leasing sector to continue to grow, albeit at a slower pace than in 2019.

A key driver of the expected growth of the co-working office leasing sector is the expansion of the co-working user group. The co-working model was first adopted by entrepreneurs, both individuals and small companies, many of whom had little to no credit. While such uses will continue, the co-working model is also attracting larger companies. Larger companies are beginning to look to co-working space not just to solve short term space needs, such as using co-working space as "flex space" to accommodate a rapid expansion or contraction of personnel, but also to serve as satellite offices or to house specific individuals who may not have easy access to the company's main offices. The typical short term nature of co-working subleases will offer these companies greater flexibility in their space planning and personnel needs, and can be valuable supplement to their other typical office leases.

Some landlords have begun offering co-working and flex spaces directly to users without the use of the traditional co-working "middlemen" such as WeWork. It's too early to assess this trend, however, due to potential financial considerations. Co-working leases tend to be short term, and co-working users traditionally have limited credit. Therefore, large scale use of direct leases with co-working users could have a negative effect on the valuations of the buildings where such co-working occurs.

As is the case with new office space intended for tech company use, we'll see new office product designed with the co-working model in mind.

Medical Office

Medical innovations are spurring changes in the medical industry. A confluence of factors, such as the aging U.S. population and increasing lifespans, coupled with new medical technologies/outpatient procedures and insurance companies' push for outpatient care in an effort to reduce costs, has led to steady growth in medical office demand. We expect that trend to continue in 2020.

Demographics likely will drive increases in medical office leasing. Health care spending makes up almost 18% of the gross domestic product, and more baby boomers than ever are 65 or older, which is an important milestone for Medicare and Medicaid. With medical costs rising along with an aging U.S. population, the demand for medical services at medical offices, as opposed to more traditional hospital or surgery center settings, likely will continue to rise.

In summary, as the U.S. continues its economic growth into 2020, the commercial real estate sector, and office leasing in particular, will likely also continue to grow in 2020. Tech companies' user demand likely will increase, with the most leasing activity occurring in those office buildings best suited for tech companies' requirements for amenities. Co-working likely will continue to evolve, with large corporate users taking advantage of co-working space for their flexible office use needs. Finally, medical office needs likely will continue to expand as our population ages and medical uses shift away from traditional hospital settings.

THE RETAIL AND COMMERCIAL DEVELOPMENT GROUP OF COX, CASTLE & NICHOLSON LLP

The Retail and Commercial Development Group of Cox, Castle & Nicholson LLP has extensive experience in acquiring, developing, constructing, leasing, financing, and disposing of all types of retail projects, including regional enclosed malls, lifestyle community centers, and neighborhood centers, as well as office and mixed-use projects. Members of the Retail and Commercial Development Group include attorneys who are experts in sales and acquisitions, reciprocal easement agreements, development and management agreements, and leasing, and generally represent shopping center, office, and industrial developers, as well as major retailers.

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