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SPACE SQUEEZE

Folsom and El Dorado Hills are prime for new industrial developments

BY STEVEN YODER

Bob Kuhl has been around the Sacramento commercial real estate market for 42 years.

For 37 of those, he ran his own commercial real estate company and today he's senior vice president at Cemo Commercial based in Folsom. But even for a village elder, there's a first time for everything. "I've never in my life told a client that I don't have anything [to lease]," he says. "And not only don't I have anything, but nobody else I know has anything."

Absent new building, that's the future of industrial property in Folsom and El Dorado Hills. And it's a case study of what's happening across the region.

Two recent reports show the current state of leasable industrial space. Across the Sacramento area, industrial rents are at a five-year high and will hit

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all-time records next year, according to a first-quarter 2017 report by real estate services firm Cushman & Wakefield. But even as prices spike regionwide, the market in El Dorado Hills and Folsom stands out — its rents for industrial space are second-highest among Sacramento's 16 sub-markets, according to a second-quarter 2017 report by commercial broker Colliers International.

offices in the front of the building while keeping the back for a warehouse. Kuhl sees it as a market dominated by small warehouse spaces of 5,000 to 10,000 square feet — the type sought out by contractors. And it caters to businesspeople who want to live locally — someone who bought a house in the area a few years ago but is tired of jamming onto Highway 50 every morning to get to downtown, Kuhl says.

The El Dorado Hills and Folsom industrial-space market may be unusual, but its market dynamics are typical of the region. "It's harder and harder to find good quality [warehouse] products," says Zac Sweet of commercial development and management company Buzz Oates. The Sacramento area's vacancy rates are averaging 6.4 percent — the lowest since 2000, according to the Cushman & Wakefield report.

If you're a commercial tenant or buyer, it actually may be worse than that. Cushman & Wakefield's Matt Cologna says that a few large vacant industrial buildings across the region (more than 100,000 square feet) are skewing the numbers. If you subtract those, his back-of-the-envelope calculation shows a real vacancy rate of 4.6 percent. A healthy commercial vacancy rate, one that gives landlords and tenants some parity in leverage, runs 8 to 12 percent, he says. "The supply-demand curve is way out of alignment," Cologna says. And that hurts the region's reputation as a place to get affordable industrial rental rates. Tenants up for renewal are sometimes seeing 20-percent increases, according to Cologna.

California's green revolution has a role in the scramble. With marijuana growers snapping up properties nearer downtown, traditional tenants like framers and plumbers are crowding into sub-markets like Folsom-El Dorado, says Rutherford.

What's most needed in Folsom-El Dorado are more of the flex and light industrial spaces that the area already has.

"In the last 12 months or so, it's turned from a tenant's to a landlord's market," says Jason Rutherford, senior vice president at Colliers International, who lives and has listings in El Dorado Hills. The tightening is regionwide but most acute in places like El Dorado and Folsom, which lack product because there's been no construction in 10 years. "Landlords are now able to dictate terms," he says. "It used to be easy to say on any given deal that you'd get a month of free rent per year of the term. That's not the case anymore." Landlords have also turned into wary suitors, scrutinizing the potential tenant's industry and balance sheet in a way they previously didn't.

Folsom and El Dorado Hills represent a specialized type of market for industrial space. Rutherford defines it as a "flex" market — buildings that allow occupants options, like putting a showroom and

"It won't be the 100,000 square-foot buildings ... but it appears there are a lot of companies that need 5,000, 15,000, 20,000 square feet, and those buildings just aren't available," says Sammy Cemo, head of Cemo Commercial, who in 1983 began developing what became the El Dorado Hills Business Park.

But the market is stuck in mid-cycle: rents are rising fast but still aren't high enough to justify building. "Right now you can rent warehouse [space] for 50, 60, 70 cents a square foot," says Cemo. "But to put up a new building that has a 5,000 to 10,000-foot warehouse component, you'd have to get a dollar for it. When you throw those numbers out there, [developers] who think they're interested just go away."

Labor, market and regulatory conditions are making it tough for those financial projections to work. Since the 2008

crash, banks are less willing to finance speculative versus build-to-suit projects that are pre-leased before the first shovel goes in the ground, says Cemo. Also, a labor shortage in construction is driving up costs. And fees that municipalities charge developers to deal with the impact of their projects, like traffic mitigation, are rising, he says. For example, in the last 20 years development fees for office construction have gone from below \$5 a square foot to \$15 a square foot today, he says. Developers have to add that to their sales or lease prices to recoup their costs.

Kuhl thinks there's another, lesser-known problem — the graying of the construction workforce, and that of many other industries, has come to commercial real estate. "I'd speculate that in the last 15 years most of the guys who made a living being real estate developers got

burned, just said screw it and retired — the market took such a long, deep dive," says Kuhl. "I'm not seeing a lot of young developers coming into the field."

But Kuhl's long history makes him an optimist. Given developers' inability to build on spec because of banks' reticence to lend, he thinks the solution in El Dorado Hills, Folsom and elsewhere is for builders to start leasing up properties before they launch. "You build a couple and sell a couple — there have got to be ways to do it," he says. Despite the obstacles, he thinks it will happen: "I'm pretty bullish on what we're seeing out here." ■

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