Los Angeles

Orange County

San Diego

San Francisco

JUNE 2008

ALLEN MATKINS/UCLA ANDERSON FORECAST

California Commercial Real Estate Survey

Allen Matkins

UCLA Anderson FORECAST

UCLA ANDERSON FORECAST STAFF

Edward E. Leamer
Director
UCLA Anderson Forecast

David Shulman
Senior Economist
UCLA Anderson Forecast

Ryan Ratcliff
Economist
UCLA Anderson Forecast

Jerry Nickelsburg
Economist
UCLA Anderson Forecast

Sherif Hanna
Managing Director
UCLA Anderson Forecast

Patricia Nomura
Economic Research/Managing Editor
UCLA Anderson Forecast

George Lee
Publications and Marketing Manager
UCLA Anderson Forecast

Winnie Ocean
Program Manager
UCLA Anderson Forecast

Kristen Schoeck
Marketing Coordinator
UCLA Anderson Forecast

Paul Feinberg
Editorial
UCLA Anderson Forecast

More detail on the construction and methodology behind this survey can be found in the Allen Matkins/UCLA Anderson Forecast California Commercial Real Estate Survey Support Document available at www.uclaforecast.com.

Welcome to the Allen Matkins/UCLA Anderson Forecast California Commercial Real Estate Survey and Index

Our ability to predict the real estate markets helps us make better business decisions. Understanding the timing of markets is critically important to our decisions. Because of the long lead times for real estate development, general economic conditions, such as job and income growth, are not generally in phase with the real estate business cycle.

Allen Matkins and UCLA Anderson Forecast have partnered to create a Commercial Real Estate Survey and Index to better predict future California commercial rental rates and vacancy rates. This new tool surveys supply-side participants – commercial developers and financiers of commercial development – for their insights into their markets. The Survey and the resulting Index will provide a measure of the commercial real estate supply-side participants' view of current and future conditions. Since participants will be taking investment actions based upon these views, it will provide a leading indicator of changing supply conditions.

Through an analysis of the Index and the incorporation of the Index into other economic forecasting models, the survey is designed to provide more accurate information on future office, retail and industrial space in major California geographical markets. This third survey installment covers the Los Angeles, Orange County, San Diego and San Francisco area commercial office markets. Follow-on surveys will cover other commercial asset types, including retail and industrial development, and other major California markets.

The Allen Matkins and UCLA Anderson Forecast Partnership

At Allen Matkins, the top-ranked California-based law firm servicing the real estate industry according to Chambers & Partners, we have been fortunate to work with and assist leading institutions, developers and lenders in the real estate industry. We have prospered, along with our clients, in this vital sector of the California economy. We are sponsoring this Survey to provide value to the industry. We have partnered with UCLA Anderson Forecast, the leading independent economic forecast of both the U.S. and California economies for over 50 years, and have tapped the knowledge of the leading developers in the state to provide what we believe will become the best, clear-sighted forecast of the California commercial real estate industry.

We hope you will find this new Survey to be helpful.

John M. Tipton

John M. Tipton
Partner, Real Estate Department
Allen Matkins Leck Gamble Mallory & Natsis, LLP

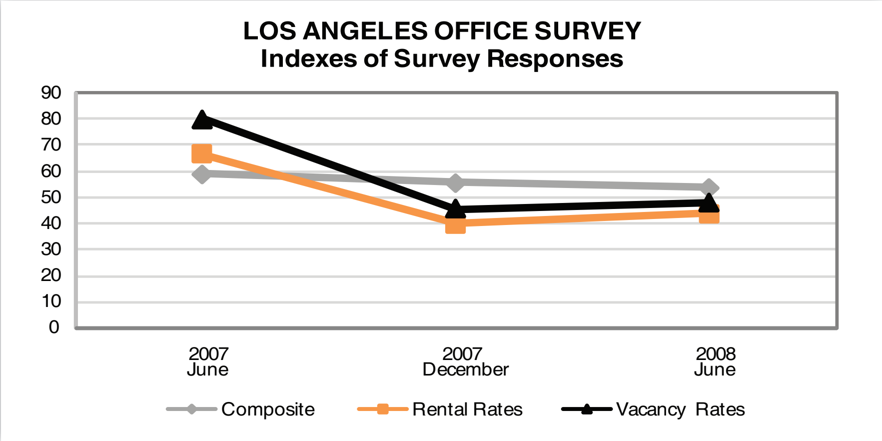
California Office Markets: Signs of Optimism?

Tight credit markets, a soft economy, and the implosion of the home mortgage industry are the grist of pessimism in some sectors of the commercial real estate industry these days. But all is not doom and gloom. At the May National Association of Realtors Meeting, Chief Economist Lawrence Yun stated "Commercial real estate conditions are uneven across the country ... but commercial fundamentals are good." This characterization of the U.S. is a perfect description of the commercial office markets in California. According to the Allen Matkins / UCLA Anderson Forecast Commercial Real Estate Survey's panels of real estate professionals in Los Angeles and in San Diego, some California markets are doing just fine. Others, such as Orange County and San Francisco seem to be marking time, but the Survey panels for those markets are not predicting disaster. The Survey, conducted for the third time over the past two years at the end of May, compares the panelist's forecasts of the market three years hence with today's market. This captures existing market conditions, development projects in process, and developments whose fruition depends critically on near-term market conditions. In the two markets where the panelists were the most optimistic, Los Angeles and San Diego, there was a sense that while credit conditions were going to remain tight, the credit crunch which brought financings to a halt last December was beginning to abate. In Orange County, the other region in both the December and May Survey, the opposite seemed to be true. It may well be that this differential in direction, albeit slight, is reflective of financiers being more selective in their choice of markets and choice of investments within each market.

Los Angeles Settles Into Good Times

Los Angeles is the market we have been following the longest. The first Allen Matkins / UCLA Anderson Forecast Survey was taken a year ago and it found Los Angeles developers and investors very bullish on the office market. Since that time, the view three years out into the future has cooled, but much has happened as well. Rental rates for office space have climbed 7% after adjusting for inflation and vacancy rates have remained virtually flat. These were the changes that our panel expected last June and which led to our characterization of Los Angeles as a red hot market. Now, while the panel remains somewhat bullish, it does not think that the market will improve much over where it is today. The Los Angeles Survey Response Chart shows the index values for the composite of all questions, the vacancy rate question and the rental rate question for each of the three survey dates. A value around 50 indicates a market three years out which is substantially the same as today and values significantly above a tightening market and significantly below a weakening market. All

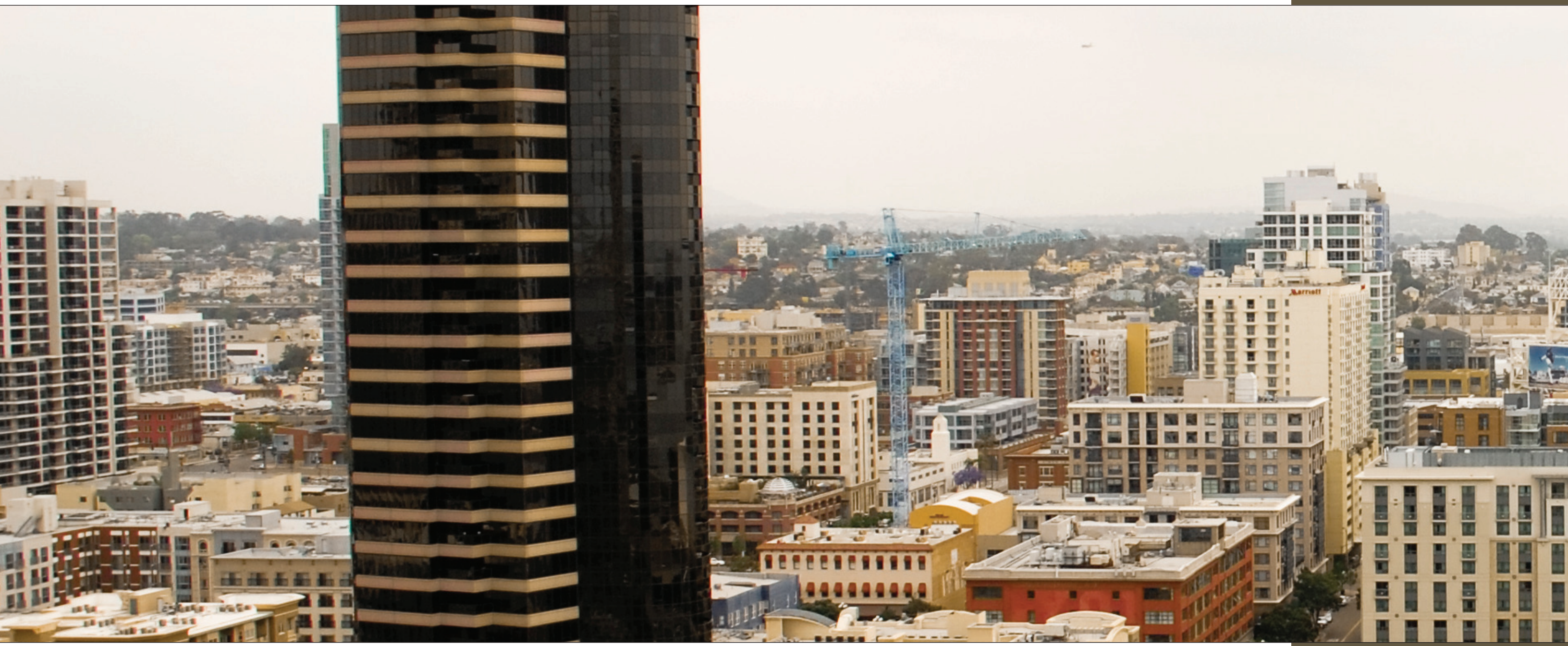
Jerry Nickelsburg
Economist
UCLA Anderson Forecast



three measures are right around 50 for the current survey.

The decline in the indexes from a year ago is not bad news at all. It implies vacancy rates in Los Angeles staying at levels lower than experienced in the last 20 years, and rental rates which imply a stable future evolution of market fundamentals. Today's market represents a healthy office space market and with new supply expected to come on the market over the next three years at a rate just about equal to the expected increase in demand - the market will remain healthy.

To contrast the panel's responses to our economic model, we find that they are predicting a larger increase in the stock of office space than past experience would suggest. Our model has rental rates adjusted for inflation increasing about 2% over the next year and then increasing at a slightly faster rate thereafter. Thus, the economic model is predicting upward pressure on pricing to continue to bring new office space into the market. The occupancy rate over the time horizon of the panel's forecast is unchanged from today. So, both the panel, and the model based on external data are showing the Los Angeles Office Market holding up and settling in to three more years of growth after 2008. For investors it means picking new developments in the growth sub-markets and being well positioned to pick up demand as it comes into the market.



San Diego: Let the Good Times Roll

San Diego is the surprise of the survey. The San Diego residential market has been hard hit by the housing crisis and the real estate and mortgage finance business was felt in the office space market. We conducted the first survey of our panel last December and they were decidedly pessimistic. The composite index, rental rate index, and vacancy rate index all indicated that the panel saw a weaker office market between December 2007 and December 2010. In the latest survey, all three of these indicators are higher. Specifically, the panel sees the market tightening out to 2011 with both occupancy rates and rental rates higher. Why the turnaround? The answer stems from the growth in office using employment. Although San Diego did not make much progress in the first quarter of 2008 in terms of overall job growth, outside of finance, office space using employment grew in the first quarter 2008 from the first quarter 2007 by 1.5%. Job loss in finance changes this growth rate to be negative and may continue to do so for the balance of 2008, but the survey suggests two market forces at work. First, the panel feels the drag of finance is about over and other parts of the San Diego economy will take up the slack, and second, that the amount of space that is planned for entry into the office space market over the next three years is not excessive given the growth of demand.

When we look at our economic model of the San Diego office space market we find that this change in sentiments is justified by the underlying fundamentals. In late 2007, a weakening market in office space fueled by the weak San Diego economy portended falling real rental rates and rising vacancy rates. Our model shows this occurring though 2009, and the December 2007 panel's view was that it would continue into 2010. Nevertheless, the model shows that growth in office using employment would result in occupancy and rental rates in 2011 higher than those in 2007. This is simply a case of the market being weak, but not so weak as to obviate a recovery due to near term growth in employment in professional and business services, information, health and human services and other office generating employment sectors. The panel also forecasts that building and financing costs will be higher over the next three years. This provides a disincentive for overbuilding and keeps an excess supply from coming on the market. Since investors and developers are planning today for new supply in 2011, the good times seem to be back for San Diego office space owners.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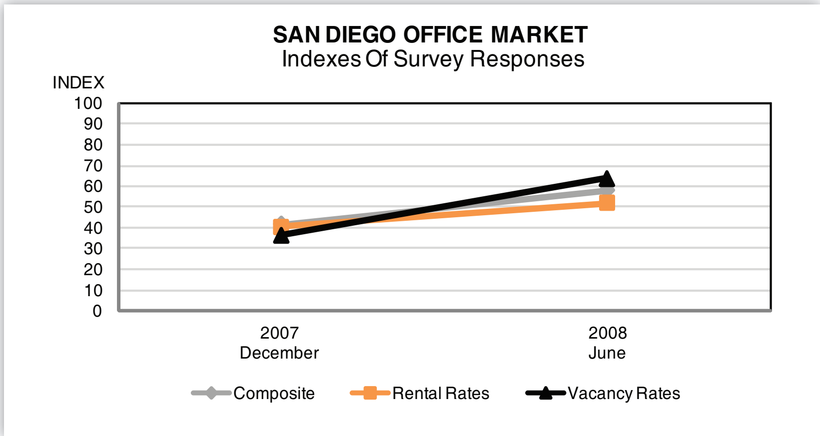
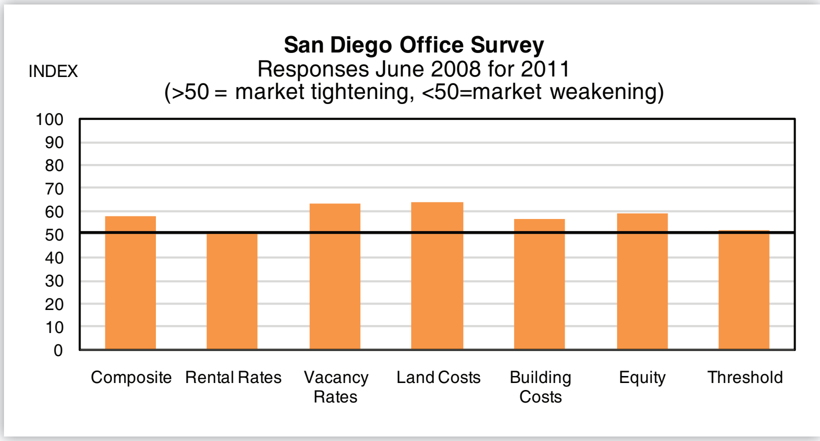

SAN DIEGO OFFICE MARKET
Indexes Of Survey Responses
INDEX
100
90
80
70
60
50
40
30
20
10
0
2007
December
2008
June
Composite
Rental Rates
Vacancy Rates

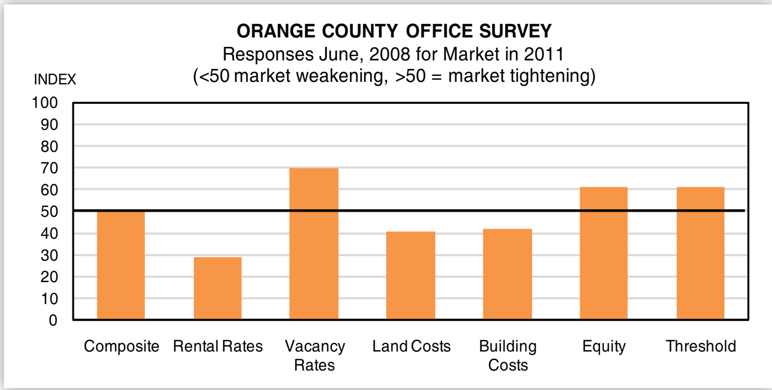

San Diego Office Survey
Responses June 2008 for 2011
(>50 = market tightening, <50=market weakening)
INDEX
100
90
80
70
60
50
40
30
20
10
0
Composite
Rental Rates
Vacancy Rates
Land Costs
Building Costs
Equity
Threshold

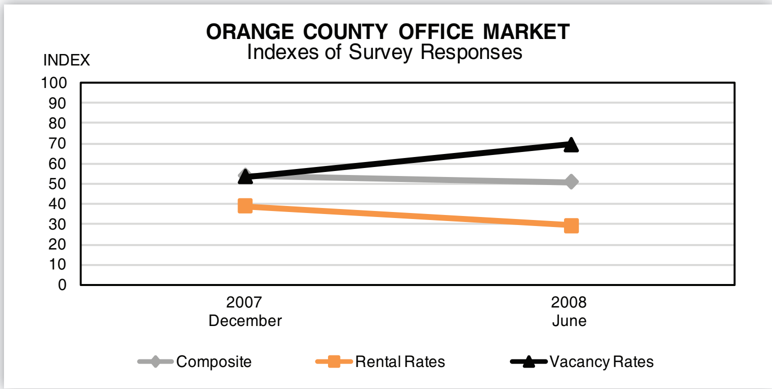
Orange County: Awaiting the End of Structural Change

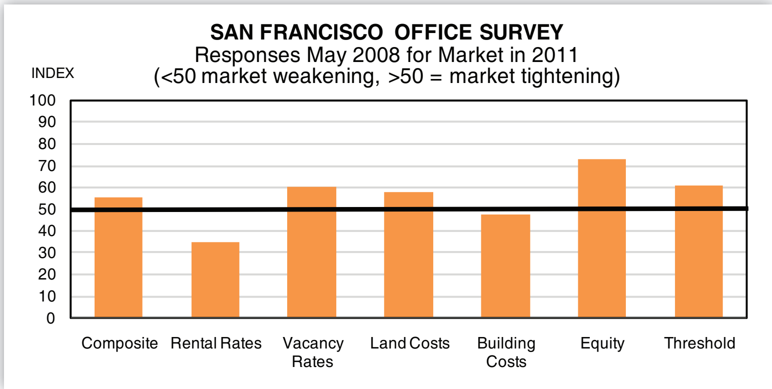
Turning now to a less robust market, Orange County, the survey finds that developers are pessimistic about this market. The survey results show downward pressure on the price of land for office space development, an unusual event for California, indicating a very weak market. With higher financing costs and slack demand this is a market where investors will have to choose their projects carefully. Overall the Orange County panel forecast the market to remain weak through 2011. The continued weakness in this market is consistent with the structural change currently under way in the Orange County economy.

In the California Report this June, we discuss structural change in the home mortgage finance sector and its impact on Orange County employment. Basically, the home mortgage industry, centered in Orange County, grew rapidly during the housing boom to serve the level of transactions occurring in an overheated national real estate market. Now that real estate market activity has declined precipitously and will trend back to normal levels of transaction activity over time. The permanent loss of jobs leaves a hole in the demand for office space in Orange County. What we found in our research of other cases of structural change was that when this occurs at that magnitude in Orange County and with the implied growth rates of the other sectors, there would be an adjustment period of about five years. What all of this means is that Orange County employment will return to levels experienced before the downturn by 2012, beyond the time horizon of the current survey. Our panel's view of this market is consistent with the other evidence we have on employment.

What is new from the panel is the view that in spite of the weak market, occupancy rates will increase. The increase in occupancy and decrease in real rental rates signifies a market in which the owners of office space do not believe it makes sense to wait for higher rents as the market improves. In other words, improvement in rental rates is far enough in the future that getting tenants in now is the profit maximizing strategy. So, for Orange County we have a more competitive market for office space leases, and on balance, a weaker market over the three-year time horizon.







San Francisco: The First Survey

This round we added the San Francisco office market to the survey. While one cannot read too much into the first data point, it is interesting to see the pattern of responses. The panel's analysis of the current San Francisco market is similar to the Orange County market except that land costs are seen to be a more significant factor in the supply equation. The panel forecasts that occupancy rates would go up at the same time as real rental rates are going down. This is characteristic of a market which is weak. But office using employment has been increasing in recent years and real rental rates and occupancy rates are finally going up again.

One explanation for the disparity may be a hangover of expectations from the 2001 recession. Beginning in 2001, the computer/software/internet industries in the Bay Area underwent a structural change similar to that currently being experienced in Orange County. The adjustment process was almost over when the housing market in the Bay Area began to contract. According to our analysis, but for the slowdown in the U.S. economy, the San Francisco market would have achieved approximately the same size as 2001 in 2008.

So the first San Francisco survey is expressing more pessimism than our model, perhaps reflective of worry that the general growth slowdown in the national economy will create a substantial delay in the completion of the structural change process. The growth in the Bay Area, the highest in California in terms of number of new jobs created, belies this pessimism. It remains to be seen if the panel is seeing enough new developments to overwhelm the weaker recovery and hence continue the weak office space market, or if this is the end of a long period of pessimism in a market whose vacancy rates went up four fold between 2000 and 2004 and whose rental rates were halved in the same period. This kind of dramatic shock can indeed have lingering effects. What is interesting here is that the recovery from structural change going on in San Francisco could result in a shortage of office space by 2011 – the opposite result of the panel's assessment – as a consequence of the pessimism of investors and financiers. Moreover, how this structural change plays out will be instructive for understanding the future evolution of Orange County's office market.

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Fred Allen
Partner
Allen Matkins Leck Gamble Mallory & Natsis LLP

Mike Matkins
Partner
Allen Matkins Leck Gamble Mallory & Natsis LLP

John Tipton
Partner
Allen Matkins Leck Gamble Mallory & Natsis LLP

William Devine
Partner
Allen Matkins Leck Gamble Mallory & Natsis LLP

Tony Natsis
Partner
Allen Matkins Leck Gamble Mallory & Natsis LLP

Adam L. Stock
Director of Marketing & Business Development
Allen Matkins Leck Gamble Mallory & Natsis LLP

Cary Lefton
CEO
Agora Realty and Management, Inc.

Marc Jones
First Vice President
Arden Realty

Paul King
FVP San Diego Region
Arden Realty

McClure Kelly
Vice President
Beacon Capital Partners

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Sr. Vice President - Leasing
Boston Properties

David Simon
Managing Director
Broadreach Capital Partners

Tom Bracken
SVP
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Global Head of Research
CB Richard Ellis Investors

Chris Pascale
Senior Vice President
CBRE

Michael Monroe
Senior Vice President
Colliers International

Alex J. Rose
Vice President - Development
Continental Development Corporation

Richard Lundquist
President
Continental Development Corporation

William Purcell
Senior Vice President
Cornish & Carey

Mark McGranahan
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COO
Equastone

Richard Ortwein
Manager
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Bill Rodewald
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Principal
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Paul Twardowski
Vice President / Partner
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David McGrublian
CEO
IDS Real Estate Group

David Sears
Managing Director
J.P. Morgan Investment Management Inc.

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Managing Partner
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LNR Property Corporation

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EVP
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Blaine P. Fetter
Principal
Samuelson and Fetter LLC

Colm Macken
President & CEO
Shea Properties

Brian P. Ffrench
SVP/Branch Manager
Studley

Jim Buckingham
Partner
TA Associates Realty

Chantal Byne
Assistant Vice President
The Swig Company

John Cornuke
Director, Asset management
TIAA-Cref

Carl Shannon
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Tishman Speyer

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Thomas Irish
President
Transpacific Development Company

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Partner
WCB Properties

Terry Thompson
Acquisitions Partner
WCB Properties

Gary Palmer
Managing Principal
Westbrook Partners

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FORECAST

Founded in 1952, the UCLA Anderson Forecast is one of the most widely watched and often-cited economic outlooks for California and the nation. Award-winning for its accuracy, the UCLA Anderson Forecast has a long tradition of breaking with the consensus forecast to be among the first to spot turning points in the economy.

The forecasting team is credited as the first major U.S. economic forecasting group to predict the most recent recession in 2001. The team was also ahead of the pack in predicting both the seriousness of the early-1990s downturn in California, and the strength of the state's rebound since 1993.

UCLA Anderson Forecast
110 Westwood Plaza
Gold Hall, Suite B302
Los Angeles, CA 90095
Phone: 310.825.1623
Fax: 310.206.9940
www.uclaforecast.com

forecast@anderson.ucla.edu

Allen Matkins

Allen Matkins Leck Gamble Mallory & Natsis LLP, founded in 1977, is a California law firm with approximately 230 attorneys practicing out of seven offices in Los Angeles, Orange County, Century City, Del Mar Heights, San Diego, San Francisco, and Walnut Creek. The firm's broad based areas of focus include corporate, real estate, construction, real estate finance, business litigation, taxation, land use, environmental, bankruptcy and creditors' rights, and employment and labor law. The firm has also been ranked as the #1 real estate firm in California by Chambers & Partners for the last five years.

Allen Matkins Leck Gamble Mallory & Natsis LLP
515 South Figueroa Street, 7th Floor
Los Angeles, CA 90071-3398
Phone: (213) 622-5555
Fax: (213) 620-8816
www.allenmatkins.com

Marie Hsing
mhsing@allenmatkins.com

For more information on this report, call 310.825.1623, send an email to forecast@anderson.ucla.edu, or visit our website at www.uclaforecast.com.

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