

East Bay

Los Angeles

Orange County

San Diego

San Francisco

Silicon Valley



JANUARY 2009

# ALLEN MATKINS/UCLA ANDERSON FORECAST

## California Commercial Real Estate Survey

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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](http://www.uclaforecast.com).



## Welcome to the latest edition of 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 always in phase with the real estate business cycle.

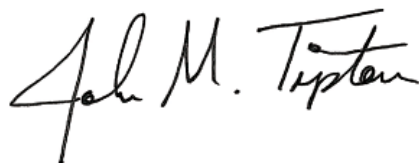
Allen Matkins and UCLA Anderson Forecast have partnered to create a Commercial Real Estate Survey and Index to better predict future California commercial rental rates and vacancy rates. This tool surveys supply-side participants – commercial developers and financiers of commercial development – for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

### 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 sponsor 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 and financiers of real estate development in California to provide what we believe is the best, clear-sighted forecast of the California commercial real estate industry.

We hope you will find this Survey and Index to be helpful.



John M. Tipton  
Partner, Real Estate Department  
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# California Office Markets: The Optimism of Summer Turns to the Pessimism of Autumn

In June, our last Allen Matkins / UCLA Commercial Real Estate Survey, we reported optimism about 2011 for Los Angeles and San Diego, and weakness in Orange County and San Francisco. It has been a very long six months. The unexpected autumnal freeze in commercial real estate credit markets and the precipitous drop in retail sales changed the outlook for new office projects dramatically.

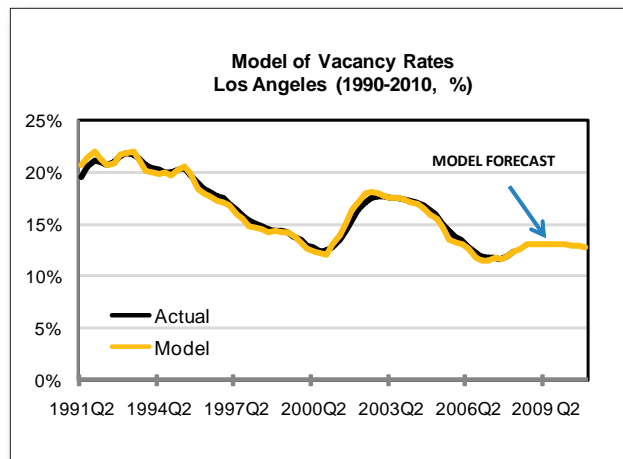
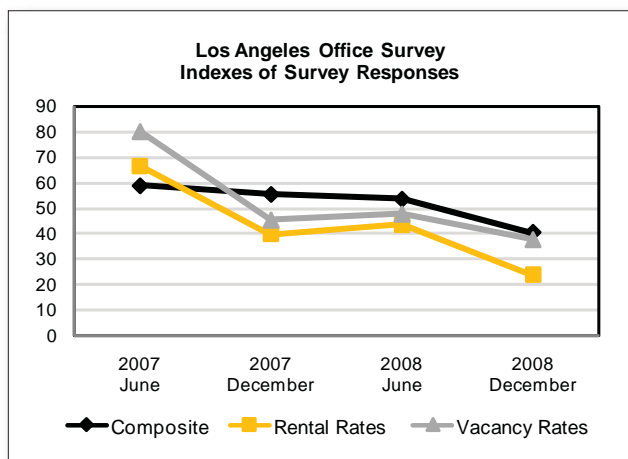
There is, to say the least, pervasive pessimism about the next three years among lessors and developers of office space throughout the state. Finance is a big part of this pessimism. "Banks are not lending" according to Scott Latham of Cushman and Wakefield; a sentiment echoed across all commercial markets by investors at a San Francisco ULI conference last month. Or, perhaps as John Kurkral, President of Northwoods Investors suggests, finance in commercial real estate today is a crisis of insufficient equity. Our panel said both are true. The change in the panel's sentiments from June to December and its impact on development decisions give us valuable insight into the future course of California's office markets.

Through the dour outlook in the survey we see evidence of turning points in the largest markets. The weakness in the balance, where fundamentals are anything but buoyant, is also evident in the survey results.

Jerry Nickelsburg  
Senior Economist  
UCLA Anderson Forecast

The survey, conducted for the fourth time over the past two years, compares the panel's forecast 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. There are individual survey panels for each of the major market areas. The current survey adds the East Bay and Silicon Valley office markets to the other four major markets. With office market coverage now complete, the Survey Research Project will turn its attention to industrial space, and roll out the first Industrial Space Market Survey results at the June UCLA Anderson Forecast Conference.



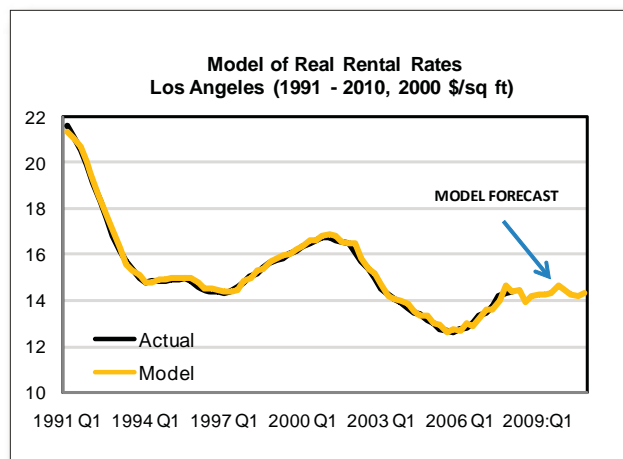


## Los Angeles: The Building Boom Ends

Los Angeles is the market we have followed the longest. The first Allen Matkins / UCLA Anderson Forecast Survey, conducted two years ago, found Los Angeles developers and investors very bullish. The maturing of the Los Angeles office building boom was to be expected and it was reflected in the 2nd and 3rd surveys. This time, our panel turned strikingly bearish. The composite index went below 50 for the first time in the November survey. A reading of below 50 indicates that the panel forecasts the market three years hence to be weaker than it is today. The rental and vacancy rate questions indicate the panel is expecting office space demand in 2011 to be weak enough to drive down both rental and occupancy rates.

The decline in the indexes from last summer represents a significant shift. At that time, the panel's view was of a relatively good market which would remain so over the coming years. The November survey reflected the view that the market, in light of the sharp economic downturn in September, is now out of balance and demand conditions will not catch up to the projected increase in supply over the next three years. Layoffs at law firms and financial institutions are fueling today's view. Those sectors are heavy users of office space, and if accounting and professional services follow suit, there could well be downward pressure on rental and occupancy rates. Developers and non-residential real estate investors have begun to act on this belief as evidenced by the nearly 50% drop in new non-residential building permits in Los Angeles since our last survey.

But what is interesting is that rental rates went up 4.7% and occupancy went down 2.4% over the last 12 months. On balance, rental revenues increased over the year. To complement the survey we use a statistical model of the demand conditions which extends to the end of 2010. What we find is that the model predicts an initial small drop in inflation adjusted rental rates, followed by a recovery in 2010.

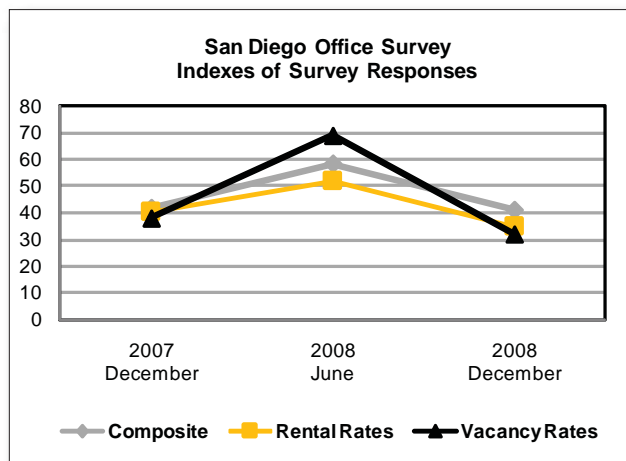


The model also predicts that vacancy rates will increase slightly and then be virtually unchanged through the balance of 2010. This is a forecast of a soft market with growth in supply just about keeping up with demand.

Since the economic recovery in L.A. should be in full swing at the end of 2010, the model is more optimistic about 2011 than the panel. The fall off in the additions to supply after completion of the 2007/2008 development projects in 2009, a boom that ended up adding less capacity to the L.A. market than either the 1990 or 1999 booms, will be minimal. Moreover, office space using employment should be the most rapidly growing portion of the L.A. economy. These suggest higher rental and occupancy rates in 2011. So we have two contrasting results. One is a supply response to current conditions and the other is a demand response to the recovery from the recession. To be sure, the near term hit of slack demand and difficult financing casts a gloom on this once bright light of California commercial building, leaving not many attractive investments for 2009. But, combining the panel's view as it affects new supply, with the economic model of demand yields a turning point in this market in late 2010.

## San Diego: Incipient Optimism, a Casualty of The Recession

In the last survey San Diego surprised us. The panel, looking out to 2011, saw reasons for optimism. The expanding demand for office space, while not creating a hot market, was sufficient given the amount of new development in the pipeline. More normal markets were expected once a decline in market conditions in 2009, a hangover from the housing downturn, was over. The San Diego residential market has been hard hit by the housing crisis and the real



estate and mortgage finance shrinkage was felt in the office space market.

The reason for the mid-2008 optimism in the face of a weak market stemmed from the growth in office using employment. In March the only sector of office space using employment experiencing a decrease in demand was finance. Though the economic news in the first 6 months of the year was bad, this situation persisted. Local economic conditions deteriorated sharply with the contraction in consumer demand in September and by November all categories of office space using employment except for government employment were in decline. With new construction being completed just as demand was ebbing, the building boom in office space in San Diego from 2006 through 2008 exacerbated the imbalance. The panel's view is that even by 2011 this market will not have recovered from its initial downturn in 2007.

When we look at our economic model of the San Diego office space demand we find that this change in sentiments is consistent with our economic forecast. Rents, when adjusted for inflation, have already begun to fall and the model predicts that they will continue to decline all the way through 2010. The lack of new supply coming on the market in 2011 and the expected growth in office space using employment should stabilize rental rates, but the model strongly agrees with the panel that rental rates will be considerably lower than today. Occupancy rates will also fall over the model forecast horizon, and vacancy rates will double by the end of next year to over 22%.



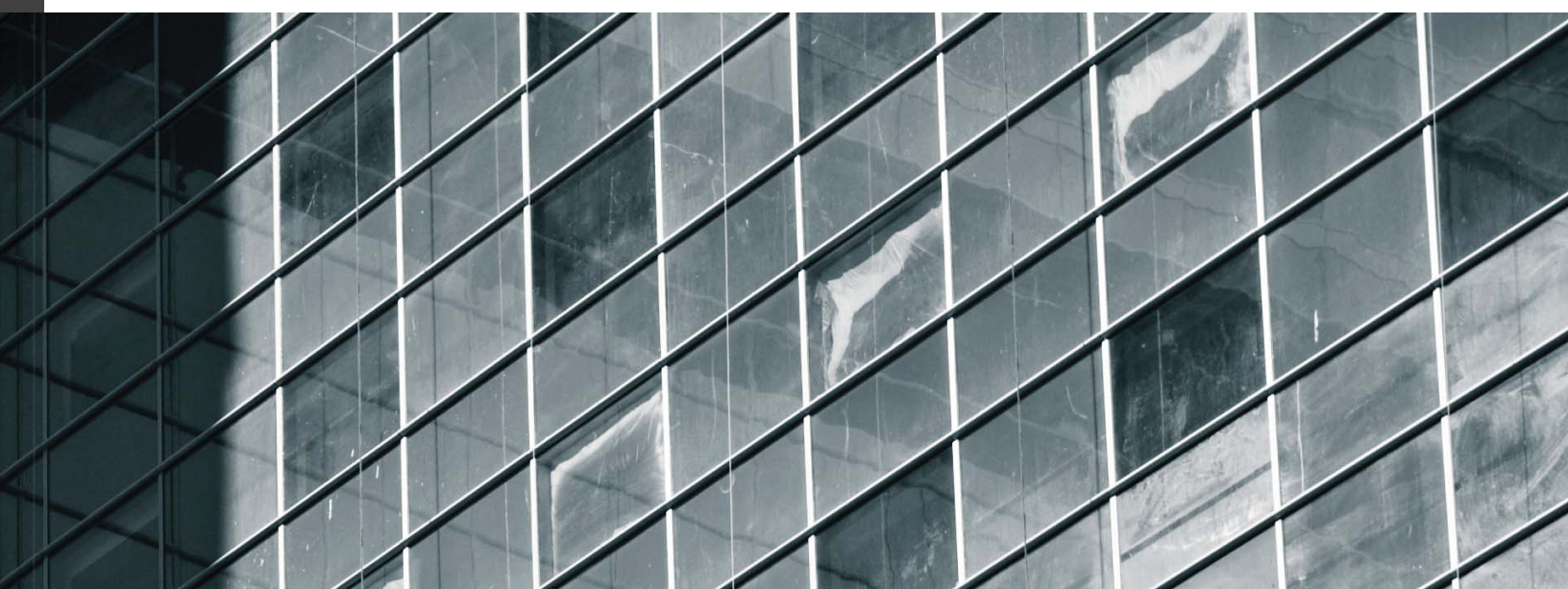
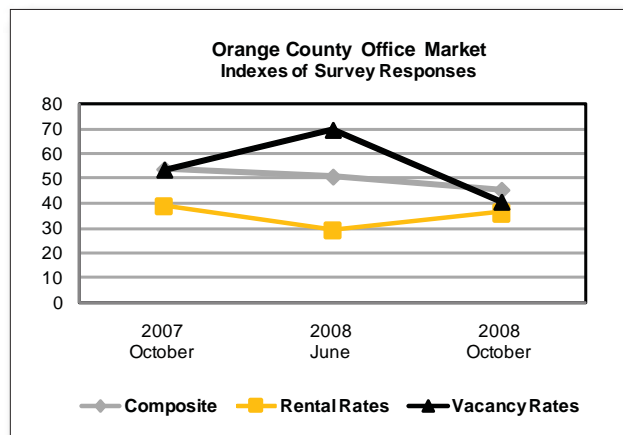
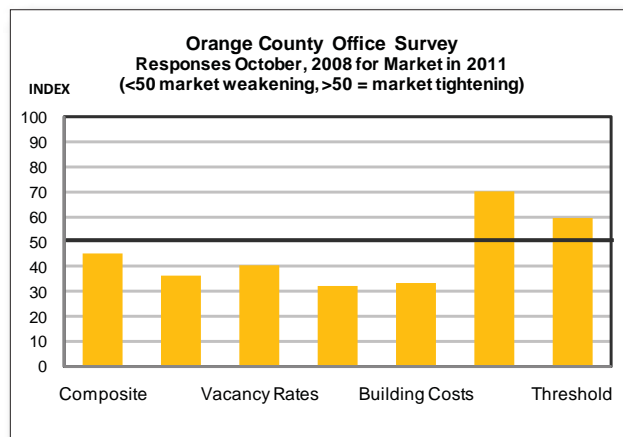
## Orange County: The Long Slow Road To Recovery Gets Longer

In October the Orange County panel was surveyed for the third time. While the panel has been pessimistic from the start, they are becoming increasingly so. The survey results show downward pressure on the price of land and building costs for office space development, and with very tight financing requirements and continued slack demand, this is a market where investors will have to choose their projects carefully. Overall the Orange County Panel forecast the market to continue to weaken through 2011. This is consistent with the structural change currently under way in the Orange County economy, made all the worse by the downturn in overall economic activity.

June's California Report discussed structural change in the home mortgage finance sector. Basically, the home mortgage industry, centered in Orange County, grew rapidly during the housing boom to serve the elevated level of transactions of an overheated national real estate market. Since 2006 market activity has declined precipitously and the mortgage finance industry has been contracting. 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 structural change occurs at the relative magnitude of Orange County's financial market contraction, and with the implied growth rates of the other sectors in Orange County, there would be an adjustment period of about five to six years. Typically, structural change begins at the beginning of a recession and the five to six years are the growth years subsequent to the downturn. Orange County's downturn in finance began a year earlier and therefore, 2009 will not be one of the expansion years. So while we were previously forecasting that Orange County

employment would return to levels experienced before the downturn by 2012, it is more likely that 2013 is the target date for a return to 2006 employment levels.



## The Bay Area: A First Look At Silicon Valley and The East Bay

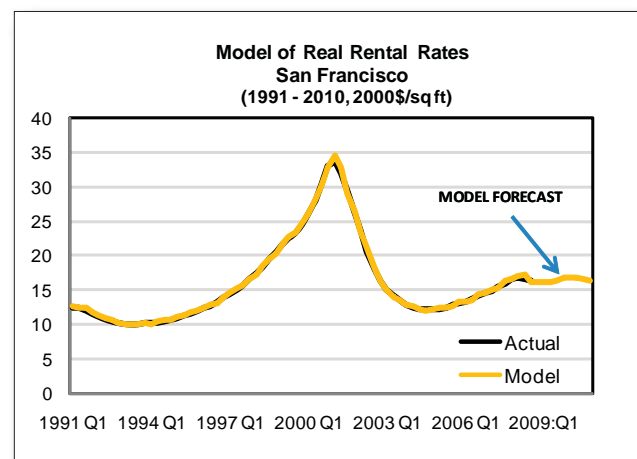
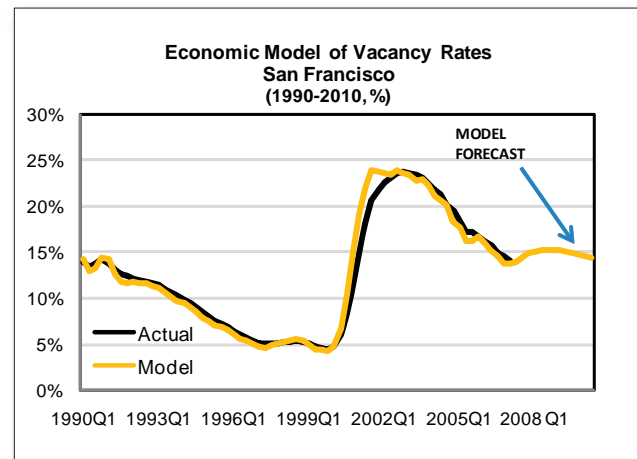
In November we rounded out the Bay Area by adding the Silicon Valley and the East Bay to the San Francisco office market survey. Though these are three distinct markets, the panel had a remarkably similar view of each. They forecast a decline in occupancy and rental rates throughout the Bay Area over the next three years.

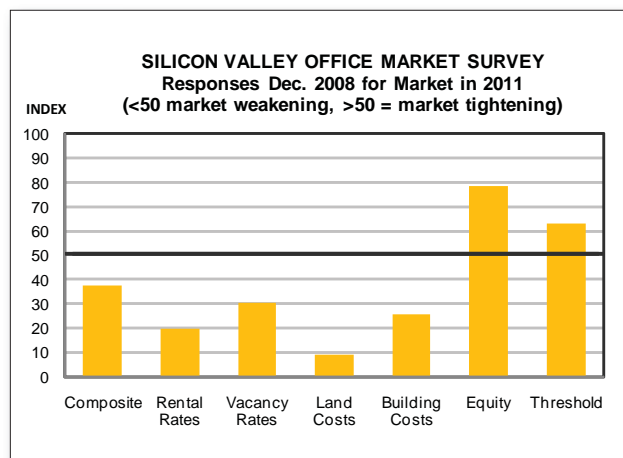
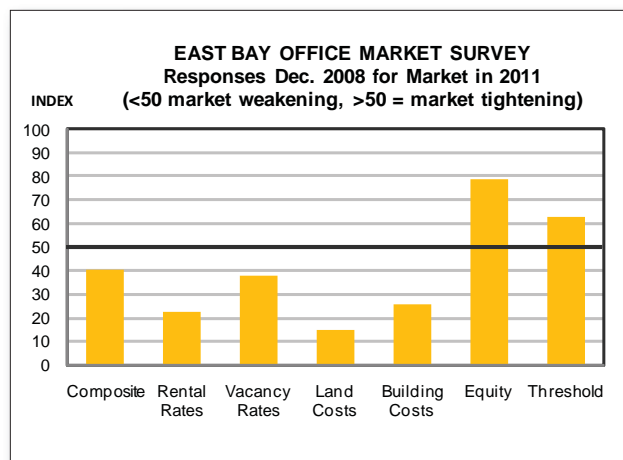
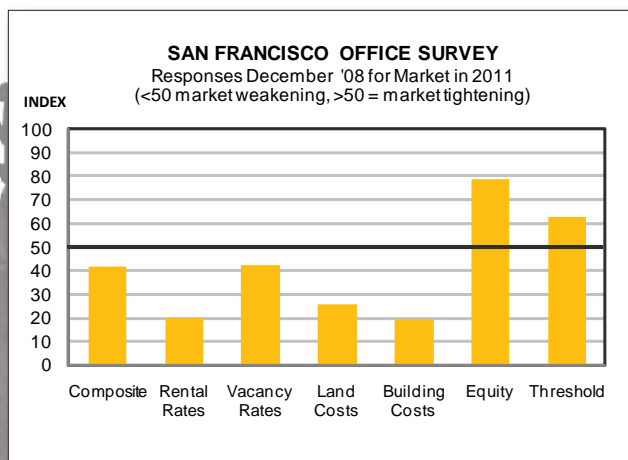
San Francisco and Silicon Valley office using employment has been increasing in recent years. After hitting vacancy rates of around 25% in 2002 following the bursting of the dot-com bubble, each of these markets has grown to mid-teen level vacancy rates. The Panel forecast is for this progress to reverse as a consequence of the current economic downturn. As in L.A., San Francisco and Silicon Valley office space investors and developers are a bit gun-shy. The value of new permits issued for office space development from June through November was down by over 50% in San Francisco/San Mateo and over 40% in Santa Clara County compared to 2007. Unlike L.A., office space development in these markets has been very moderate since 2001.

To put this in perspective we consult our statistical models. For the Silicon Valley, the models predict that vacancy rates will increase to 17.5% by the end of 2010 and that rental rates will increase at the rate of inflation. Since the return to growth will be generated by firms that more heavily use office space, 2011 ought to be better than 2010, but it might not mean a return to the relatively low vacancy rates of early 2007, nor much growth in rental rates. So, the model is more optimistic, but potentially consistent with the pessimism of the Silicon Valley Panel. The increasing demand ought to overcome the stagnant supply with a turning point for this market in 2011. For San Francisco, the model predicts that after a slight dip during the downturn (through mid 2009) the 2010 office space market will look much like today. Demand should pick up thereafter and 2011 is predicted by the models to be better than the end of 2008. So, like Los Angeles, the supply in San Francisco will not show much increase in 2009 and 2010 and the turning point in the market should be late 2010.

The East Bay is a little different. The loss of demand from finance, and professional business services associated with the downturn in housing, resulted in inflation adjusted rental rates falling and vacancy rates stagnating at around 18%. The East Bay, more exposed to the housing downturn than

the rest of the Bay Area, saw employment fall earlier than the other markets. Absorption of office space in the East Bay has been slow since the 2001 recession, and although the stock of space is not greatly changed, the recent job loss has kept vacancy rates high. Last year there was a glimmer of hope as space became more expensive in San Francisco and the East Bay looked to be a more cost effective alternative. With near term weakness across the bay and the continued loss of jobs in professional and business services, finance, and government, this glimmer has faded. Our statistical model for the East Bay model predicts sharply falling occupancy rates and rental rates just keeping up with inflation. The panel and the model are both gloomy about the near term in the East Bay.





## Final Comments

The surveys continue to enlighten us as to how market participants are responding to near term economic conditions with their future investments and the impact these actions have on future market conditions. As we build the data set some interesting market dynamics are beginning to appear. As a snapshot of today's conditions, the current surveys are pessimistic. But, they also give important clues as to the longer term supply conditions. The dynamics in the Los Angeles and San Francisco markets indicate a turning point at the end of 2010. For the Silicon Valley it appears that 2011 is a turning point, but the data are less clear. For the balance of the markets, the surveys clearly indicate a longer term adjustment process. The next survey, to be conducted in May 2009 and released at the Anderson Forecast Conference in June, will look out to 2012. We will be analyzing these new data for clues as to the turning points in the balance of the California office markets. ■

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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.

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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 six years.

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