East Bay

Los Angeles

Orange County

San Diego

San Francisco

Silicon Valley

Inland Empire

Summer/Fall 2010

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.

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

Allen Matkins and UCLA Anderson Forecast have partnered to create a Commercial Real Estate Survey and Index to better predict future California commercial rental 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 and industrial space in major California geographical markets. This seventh survey covers the major Southern California and Bay Area markets for office and industrial space.

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.

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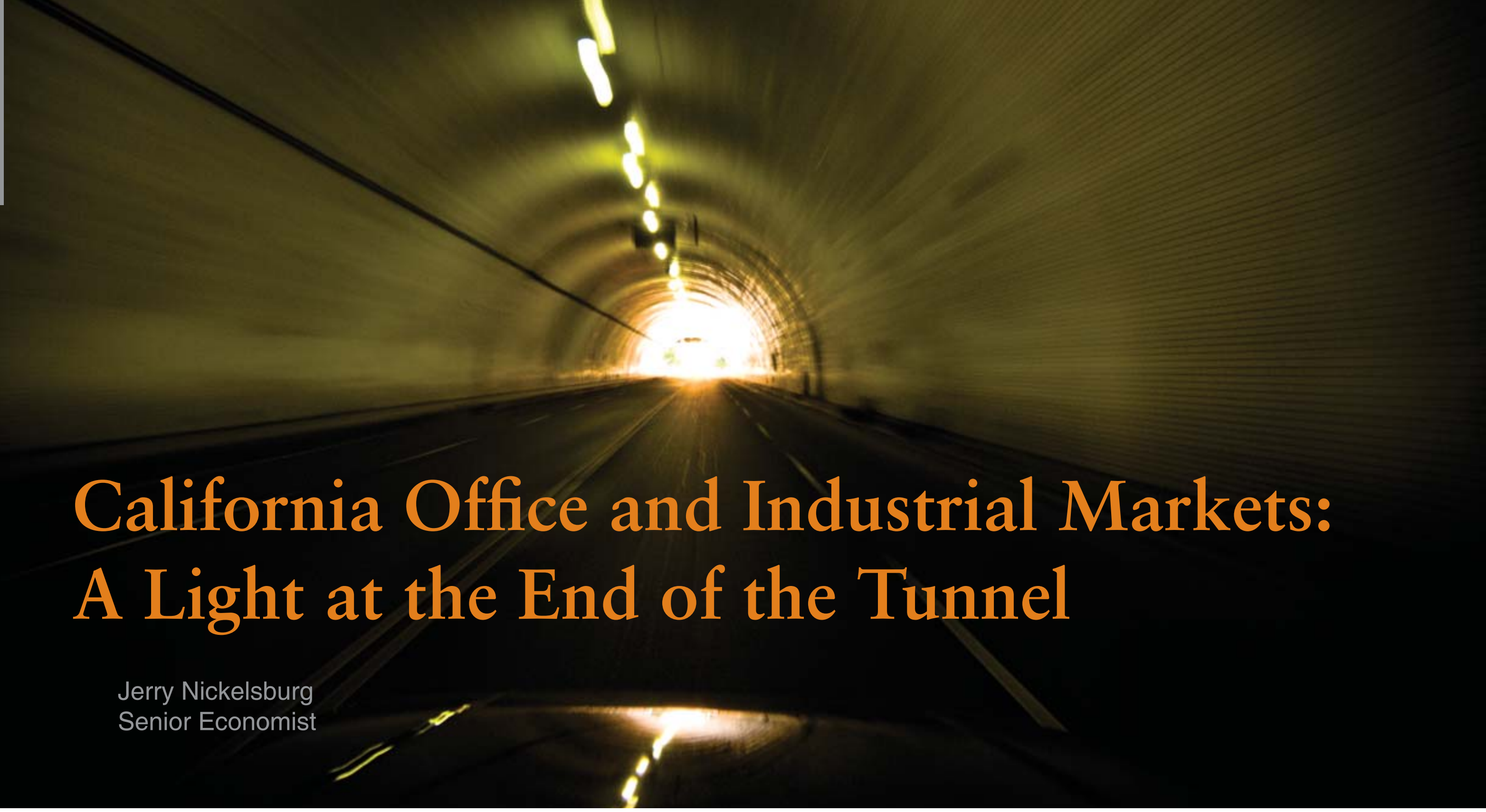
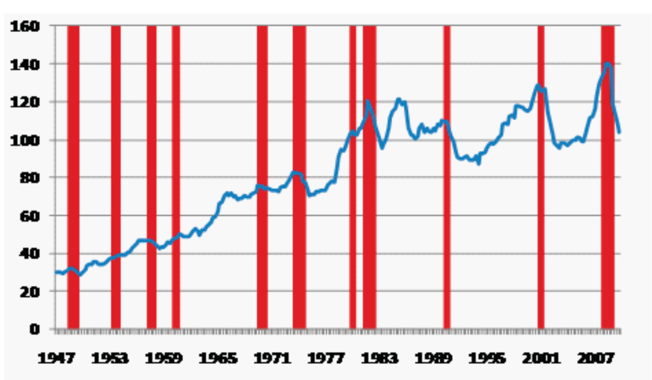


California Office and Industrial Markets: A Light at the End of the Tunnel

Jerry Nickelsburg
Senior Economist

California commercial real estate remains in the doldrums. Building is down, vacancies are up and rental rates continue to fall. Some activity is going on, but as David Marino of Irving Hughes Realty in San Diego put it; "It's just a general shell game of tenants switching submarkets… to look for more stable aggressive landlords and to get the cheapest deal.[1]" Commercial real estate is a lagging sector and even though the rest of the economy is expanding, it is typical in this part of the business cycle to see continued contraction in commercial building. The decline in construction takes over two years as existing projects are completed and no new projects take their place. After the shake-out is complete, the pattern is not so clear. Subsequent to the '69, '90 and '01 recessions, the recovery in commercial real estate markets was quite slow, and market conditions did not justify new building for several more years thereafter. After other recessions building began sooner as the recovery forced up occupancy and rental rates.

Investment in Structures (non-residential): United States (1947-2010, recessions shaded)



Source: Bureau of Economic Analysis

In this report on the most recent Allen Matkins UCLA Anderson Forecast California Commercial Real Estate Survey we find optimism returning and the distant glow of light at the end of the tunnel. The view of the market by our panel of developers, those who would initiate the process of adding to the stock of commercial real estate in the coming years for completion in 2013, is that the end of this recession will be more like 1982 than 2002. So, while we expect the doldrums to continue for some time, our panel sees a turning point in the market in the not too distant future[2].

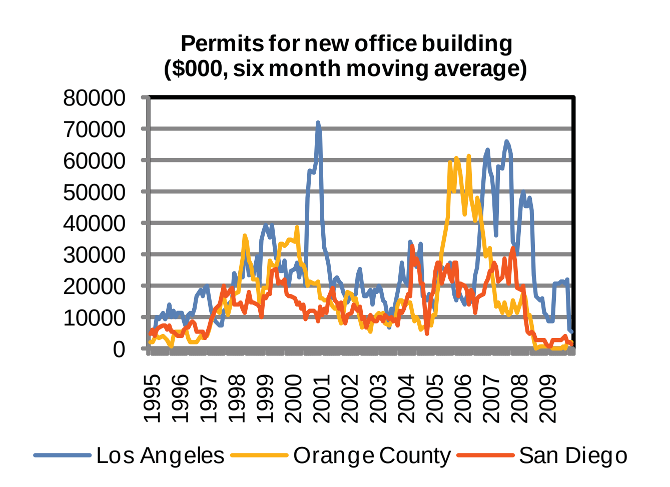
Southern California Office Markets

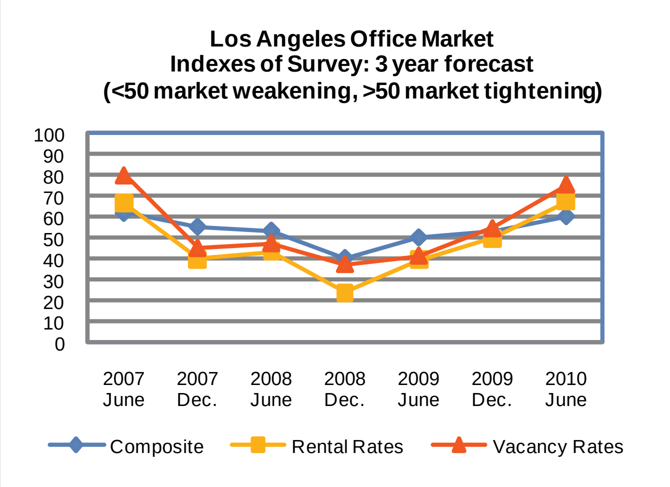
While the landscape in the office space looks much the same across Southern California, there are two different stories playing out. In Los Angeles and San Diego, vacancy rates are now in the range of 14% to 18% and asking rental rates have fallen nearly 8% over the last year.[3] But, recovery is on the horizon and there is light at the end of the tunnel in these two markets. In Orange County the implosion in the home mortgage finance industry in 2006 continues to shadow a recovery as other sectors not only have to grow back to their pre-recession levels in order demand the same amount of floor space as in 2007, but they will have to provide the demand to absorb the excess floor space left by the now defunct sub-prime lending industry. So, while there might be a light at the end of the tunnel in Orange County, we see little evidence of it yet.

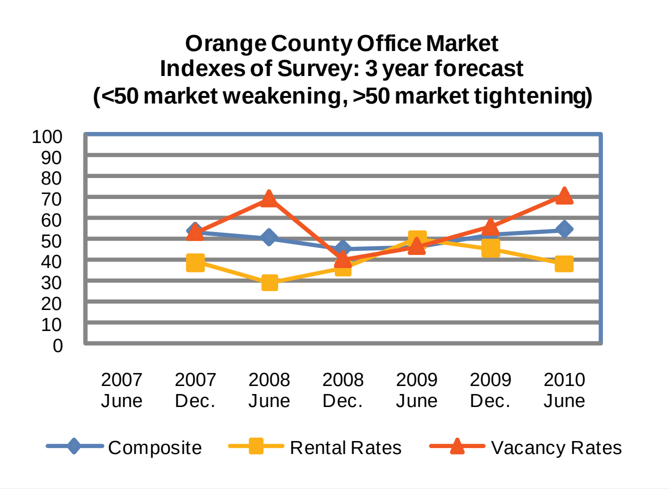
New building in Los Angeles and San Diego began to fall sharply in 2008 and reached fifteen year lows early this year. Substantial job losses in finance, and professional and business services, heavy users of office space, caused a drop in occupancy rates and a drop in the utilization of "occupied" leased space. The good news is that the mid decade boom in office space construction had not fully made up for years of moderate construction when the recession began. So, the excess supply exerting downward pressure on the market today is a function of slack demand for space and not overbuilding. As the economy recovers over the next few years, a lack of new supply combined with an increasing demand for space will absorb the current excess supply and ultimately firm markets.

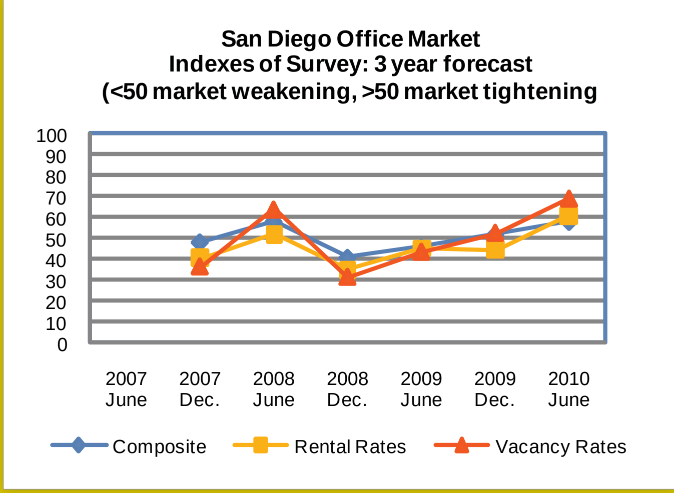
Our panel's view of the 2013 market in both Los Angeles and San Diego is now one of optimism. For Los Angeles, the index is at its highest level since the survey began in June 2007 indicating optimism with respect to both rental rates and occupancy rates. This is the first step in developers being able to pencil business plans for future construction. For San Diego the picture is similar; the panel is more optimistic in this survey then they were last December.

Orange County was ground zero for sub-prime mortgage finance. Overall Orange County saw a loss of 38,000 jobs in the financial sector from May 2005 to May 2010. This represents approximately 3% of all payroll jobs in the County and about 7% of all office using employment.[4] Because these jobs are not coming back, this creates a big employment hole for the Orange County economy to fill. Given the sub-prime implosion, this market was overbuilt. The panel for Orange County sees the market in 2013 as an improvement over today's market, but only in the sense that occupancy rates will be increasing. But in part, this is because real rental rates are falling. Thus, market conditions will not be conducive to the speculative building of new office space over the next three years.





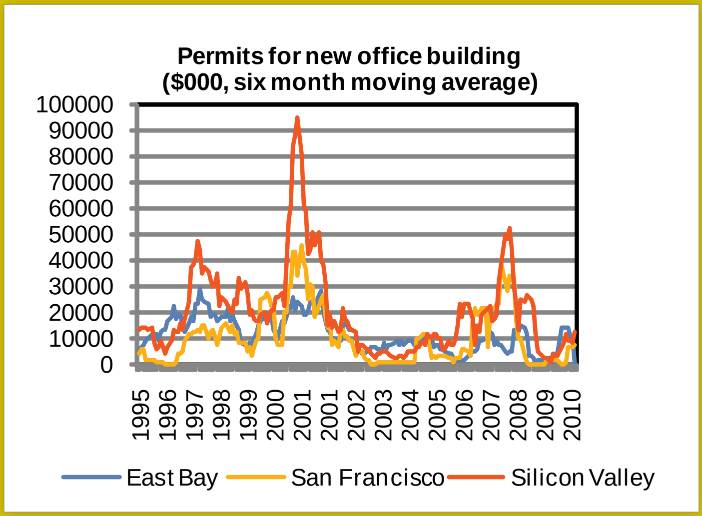


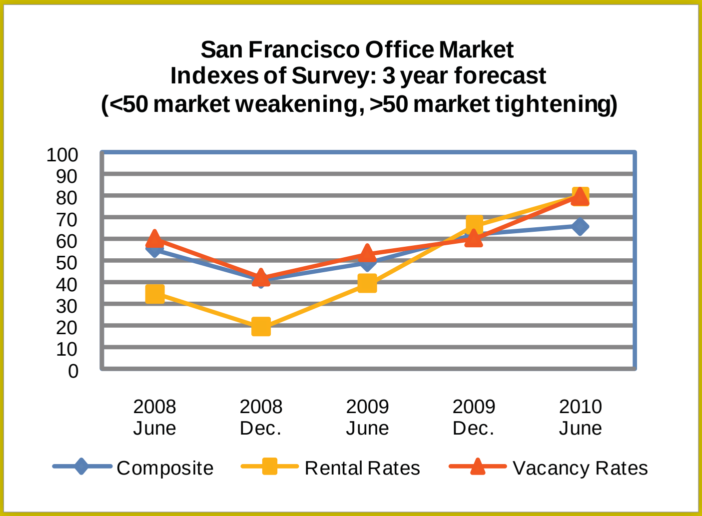


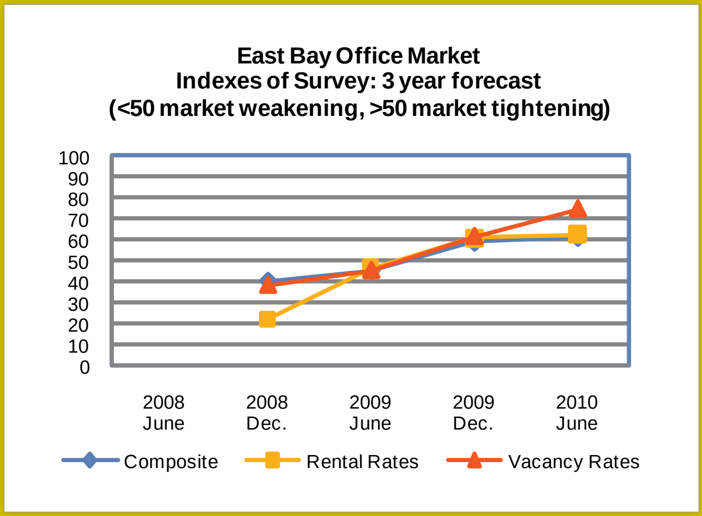
Bay Area Office Markets

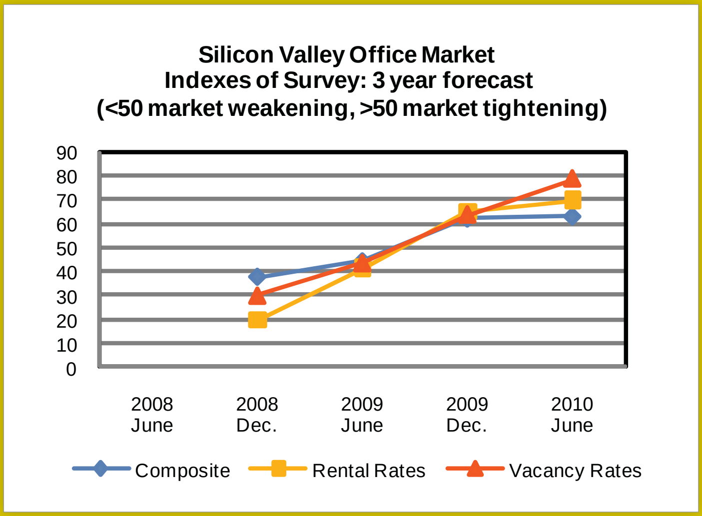
The Bay Area presents a somewhat different picture than Southern California. The dot-com bust generated an excess supply of office space and consequently very little building took place until the end of the last business cycle. For San Francisco and the East Bay the additions to office space were modest leading into the recession and have since returned to the near zero levels of the early part of the last decade.[5] So, rental rates are falling, vacancy rates are in the mid to high teens as in Los Angeles, and there is little new activity. For Silicon Valley, the increase in exports and the strength of consumer electronics demand in the 2003 to 2007 time frame led to an expansion of available office space. Timing is everything and the timing for the arrival of new office space in the Valley couldn't have been worse.[6] This is a market with significant excess supply, but unlike Orange County, it is also a market which is heavy in the higher growth sectors of the nascent recovery.

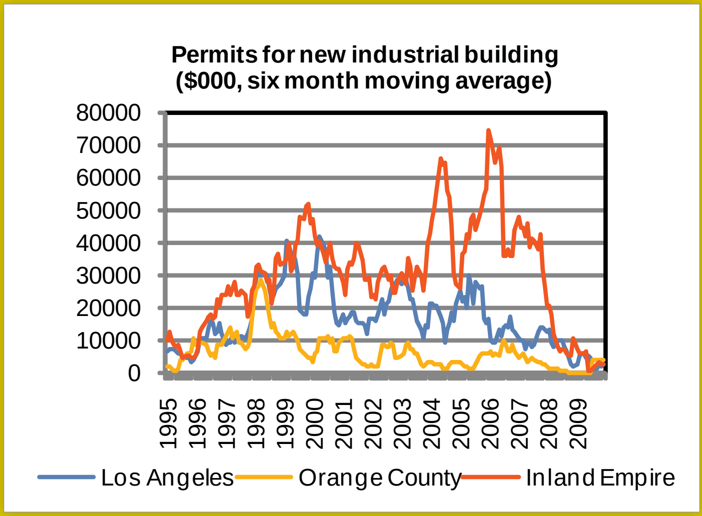
The Bay Area Developer Panel views both San Francisco and the East Bay as potentially productive markets in 2013. Their sentiment has been steadily improving since 2008. In the East Bay the Panel was no more optimistic about rental improvement relative to 2012, but it did see increased absorption leading to higher occupancy rates. In San Francisco the sentiment was for markets to improve in both rental and occupancy rates. For the Silicon Valley the sentiment was the same for 2013 as it was six months ago for 2012, optimistic, but more cautiously so.

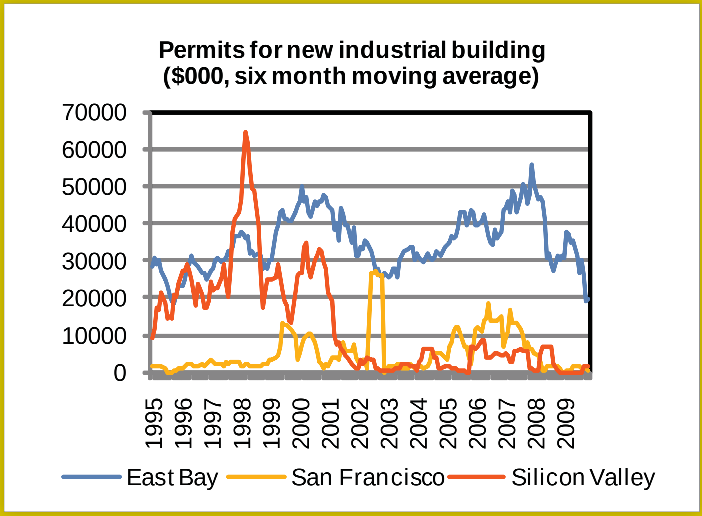

Permits for new office building
($000, six month moving average)
100000
90000
80000
70000
60000
50000
40000
30000
20000
10000
0
1995 1996 1997 1998 1999 2000 2001 2001 2002 2003 2004 2005 2006 2007 2008 2009 2010
East Bay
San Francisco
Silicon Valley

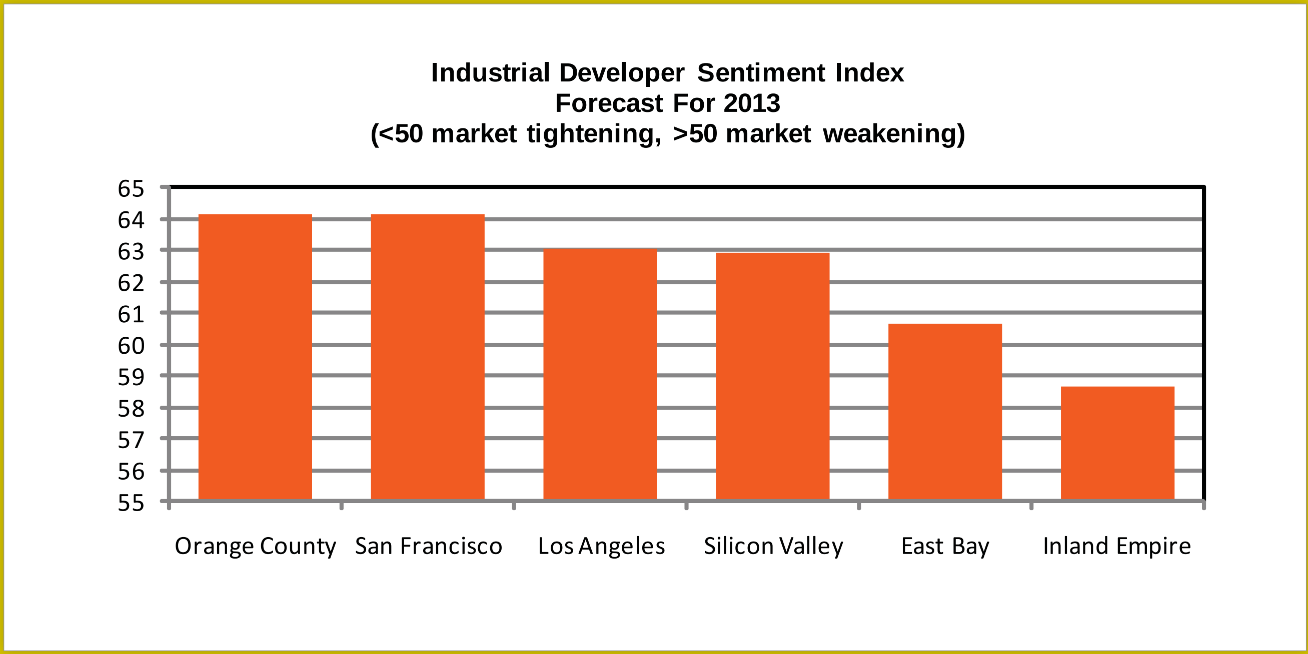

San Francisco Office Market
Indexes of Survey: 3 year forecast
(<50 market weakening, >50 market tightening)
100 90 80 70 60 50 40 30 20 10 0
2008 June
2008 Dec.
2009 June
2009 Dec.
2010 June
Composite
Rental Rates
Vacancy Rates


East Bay Office Market
Indexes of Survey: 3 year forecast
(<50 market weakening, >50 market tightening)
100 90 80 70 60 50 40 30 20 10 0
2008 June
2008 Dec.
2009 June
2009 Dec.
2010 June
Composite
Rental Rates
Vacancy Rates


Silicon Valley Office Market
Indexes of Survey: 3 year forecast
(<50 market weakening, >50 market tightening)
90 80 70 60 50 40 30 20 10 0
2008 June
2008 Dec.
2009 June
2009 Dec.
2010 June
Composite
Rental Rates
Vacancy Rates


Permits for new industrial building
($000, six month moving average)
80000
70000
60000
50000
40000
30000
20000
10000
0
1995 1996 1997 1998 1999 2000 2001 2002 2003 2004 2005 2006 2007 2008 2009
Los Angeles
Orange County
Inland Empire


Permits for new industrial building
($000, six month moving average)
70000
60000
50000
40000
30000
20000
10000
0
1995 1996 1997 1998 1999 2000 2001 2002 2003 2004 2005 2006 2007 2008 2009
East Bay
San Francisco
Silicon Valley


Industrial Developer Sentiment Index
Forecast For 2013
(<50 market tightening, >50 market weakening)
65
64
63
62
61
60
59
58
57
56
55
Orange County
San Francisco
Los Angeles
Silicon Valley
East Bay
Inland Empire

California Industrial Space Markets

In Southern California industrial space means warehouses more than factories. The huge logistics business associated with the ports of Los Angeles and Long Beach created a demand for new warehouse space throughout the region in the 90s and 00s. Indeed, the 2001 recession had only a moderating effect on the building of additional industrial space. But the collapse in consumption in September of 2008 with its corresponding collapse of imports has driven the demand for new space to record lows and halted new building projects.

Similarly, the worldwide decline in demand for manufactured goods from Los Angeles, Orange County, and the Inland Empire depressed the demand for manufacturing capacity. The Allen Matkins UCLA Anderson Forecast Survey of Industrial Space Developers, now beginning its second year shows surprising optimism about 2013 industrial markets. The optimism is somewhat greater in Los Angeles and Orange County possibly reflecting the current strength in manufacturing in the early days of this post recession expansion. Consumption spending is growing at a slow pace and growth in consumption is the key ingredient for an improvement in warehouse usage. Nevertheless, all markets are seen by our panel as having higher rents and higher occupancy three years hence.

The Bay Area industrial markets are more heavily weighted towards manufacturing than the Southern California markets. Among the three markets, logistics is more important for the East Bay. Though we have seen growth in manufacturing employment in the Bay Area, there has not been an improvement in overall developer sentiment for Bay Area industrial space since our first survey six months ago. It is difficult to draw too much from these two data points, December 2009 and June 2010, but suffice it to say that the mood, while not gloomy, is also not much improved.

Where There is Light, There is an Exit

The Allen Matkins / UCLA Anderson Forecast survey was designed to improve forecasting the evolution of commercial real estate markets. Although the survey is quite new and there is as yet not enough data for rigorous statistical analysis, interpretation of the snapshots provided by each survey provides insight into our statistically based forecasts. The optimism about 2013 in the survey, which cannot be found in the data on current market conditions, is an important indicator of both the probability of new additions to stock being started over the next two years and of opportunities for new investment in office and industrial space. After eighteen months of pessimism about office and industrial markets we are now seeing indications that, after the markets hit bottom later in this year or early next year, they will follow the pattern of increased non-residential construction coming two to three years after the end of the recession rather than the pattern of a multi-year stasis in this sector.

■

1. Roger Showley, "There's less gloom in the office market," San Diego Union Tribune, June 1, 2010.
2. For an analysis of the U.S. markets see, David Shulman, "The Outlook for Commercial Real Estate: The Rocky Road to Recovery," UCLA Anderson Forecast, June 2010.
3. Roger Vincent, "Southern California office markets continue to weaken," Los Angeles Times, April 28, 2010.
4. Roger Showley, "There's less gloom in the office market," San Diego Union Tribune, June 1, 2010.

5. Source: EDD; office using employment is approximated by Financial Services, Professional and Business Services, Education, Health Care and Social Services and Government sectors. The percentage was calculated using May 2010 employment figures.
6. See for example: Office Market Report, Aegis Realty, http://www.aegisrealty.com/reports/AEGIS_Q1_2010.pdf

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The forecasting team is credited as the first major U.S. economic forecasting group to predict the 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. In 2002, the UCLA Anderson Forecast was among the first to identify the growing imbalances in the housing sector and correctly predicted sharply declining sales volumes and weak prices when rates returned to normal.

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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 seven years.

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