ALLEN MATKINS | UCLA ANDERSON FORECAST

COMMERCIAL REAL ESTATE SURVEY

Summer/Fall 2016
Issue No. 19

Allen Matkins

UCLA Anderson FORECAST


Allen Matkins FORECAST
Increase faster than the rate of inflation
B Increase slower than or at the rate of inflation
C Stay the same
D Decrease
E N/A

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

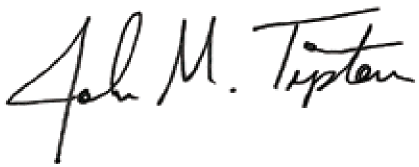
Allen Matkins and UCLA Anderson Forecast have partnered to create a Commercial Real Estate Survey and Index to better predict future California commercial rental and vacancy rates. This tool surveys supply-side participants – commercial developers and financiers of commercial development – for insights 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, industrial, retail and multi-family space in major California geographical markets. This nineteenth survey covers the major Southern California and Bay Area markets for office, industrial, retail and multi-family 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 USA*, 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 65 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
Allen Matkins Leck Gamble Mallory & Natsis, LLP

CALIFORNIA COMMERCIAL REAL ESTATE SURVEY:

TOPPING OUT IN CALIFORNIA

Summer/Fall 2016

California commercial real estate continues its boom, but as U.S. economic growth slows, the obvious question is will the boom in CRE construction continue? Commercial real estate fundamentals improve with increases in employment and income and a slowing of the growth of these is potentially of concern. The consensus forecast for California is that both jobs and income will continue to outperform the U.S., however, absorption of new commercial real estate is both a demand and a supply phenomenon. The Allen Matkins/UCLA Anderson Forecast Survey was designed not only to take the pulse of the market, but also to anticipate peaks and troughs. The June 2016 survey, reported here, provides the first indication of a topping out in office and retail markets. In the two other markets surveyed, industrial and multi-family housing, the optimism of the past few years continued through the June survey period.

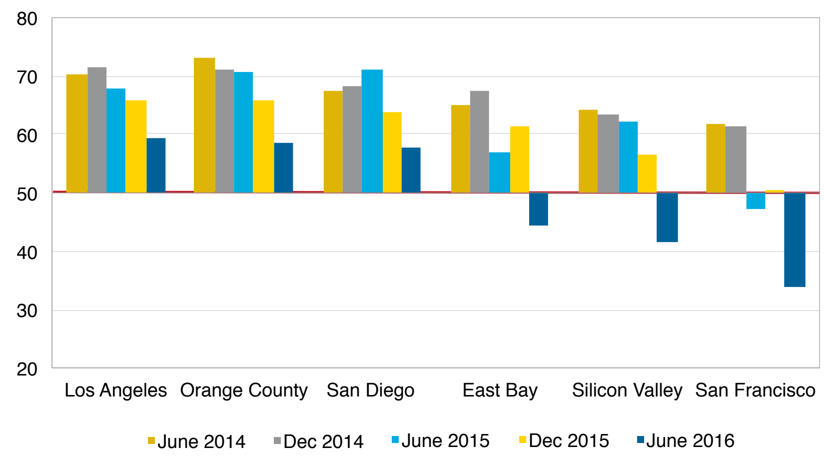
The Allen Matkins/UCLA Anderson Forecast Survey project compiles the views of commercial real estate developers with respect to markets three years hence. The three-year time horizon was chosen to approximate the average time a new commercial project requires for completion (though projects with significant environmental issues often take much longer). The panelists' views on vacancy and rental rates are key ingredients to their own business plans for new projects, and as such, the Survey provides insights into new, not yet on the radar, building projects and it is a leading indicator of future commercial construction. For example, if a developer were optimistic about economic conditions in the industrial market of Silicon Valley in 2019, then initial work for a new project with an expected ready for occupancy date of 2019--a business plan, preliminary architecture, and a search for financial backing--would have to begin no later than 2016. Although optimism does not always translate into new construction projects, this sentiment is a prerequisite for it.

OFFICE SPACE MARKETS

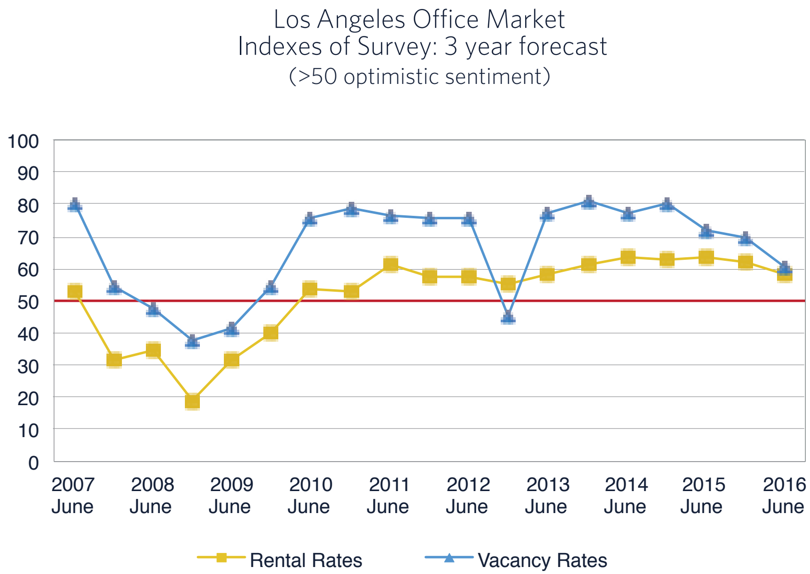
From the second half of 2009 to the middle of 2016 the panels for each of the six markets surveyed responded that vacancy rates would be declining in the proximate three years. In the San Francisco and Silicon Valley markets the panels responded that rental rates would increase faster than inflation as well. In the East Bay and in Southern California the panels came to the same conclusion in early 2010. The official end of the recession, July 2009, was not declared until September 20, 2010, as there were continued reports of a declining economy in the fall of 2009 and into early 2010. Thus the National Bureau of Economic Research (NBER) hesitated in April of that year to state that the 2008/2009 recession had ended.[1] But these official proclamations for the commercial real estate world were predicted by the forward looking Allen Matkins/UCLA Anderson Forecast index of developer sentiment.

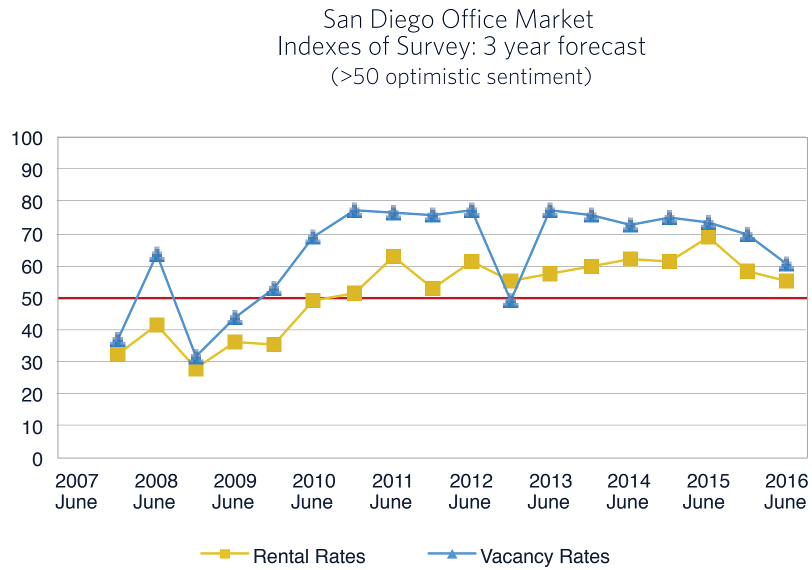
The sole exceptions to the post 2009 optimism about the years following each survey were in the fall of 2012 when there was an impending "fiscal cliff"[2] and in the spring of 2013 when there was a very real threat of an extended government shutdown.[3] Although the first was avoided and the second was short-lived, they both caused our panels to be pessimistic, with regard to vacancy rates; a sensible shading of the business plans to a more conservative stance in the face of increased uncertainty. However, overall sentiment, as shown in Chart 1 for 2014 to 2016, remained positive. Moreover, this sentiment turned into action as developers began new projects and cranes began to rise above California cities. Looking further back, the only time developer sentiment was negative during the life of the survey (2007 to 2016) was in 2007, anticipating the downturn in office space demand associated with the impending (but not yet declared) recession of 2008.

Office Space Developer Sentiment
(>50 optimistic sentiment)



1. http://www.nber.org/cycles/recessions_faq.html
2. See http://www.nytimes.com/2012/11/16/us/politics/the-fiscal-cliff-explained.html?_r=0 for a discussion of the "fiscal cliff."
3. See http://www.nytimes.com/2013/10/01/us/politics/congress-shutdown-debate.html for a discussion of the government shutdown of 2013.


Los Angeles Office Market
Indexes of Survey: 3 year forecast
(>50 optimistic sentiment)
100
90
80
70
60
50
40
30
20
10
0
2007 June
2008 June
2009 June
2010 June
2011 June
2012 June
2013 June
2014 June
2015 June
2016 June
Rental Rates
Vacancy Rates


San Diego Office Market
Indexes of Survey: 3 year forecast
(>50 optimistic sentiment)
100
90
80
70
60
50
40
30
20
10
0
2007 June
2008 June
2009 June
2010 June
2011 June
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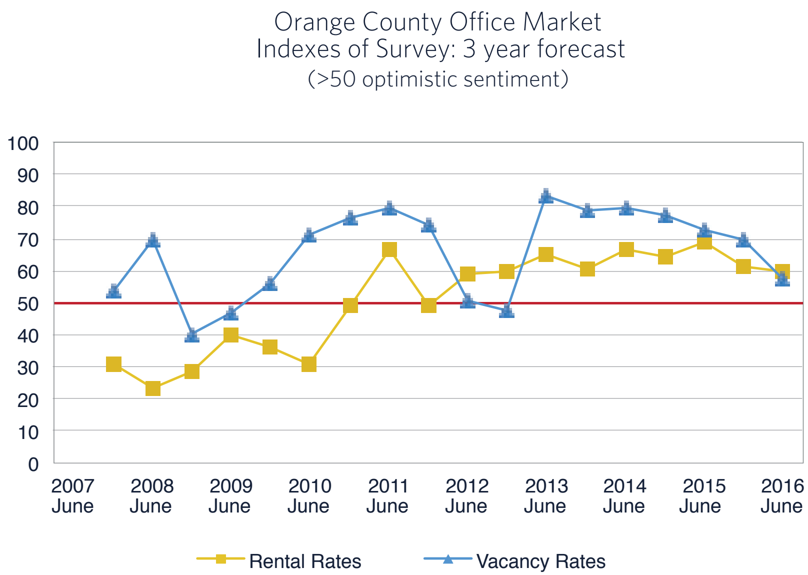
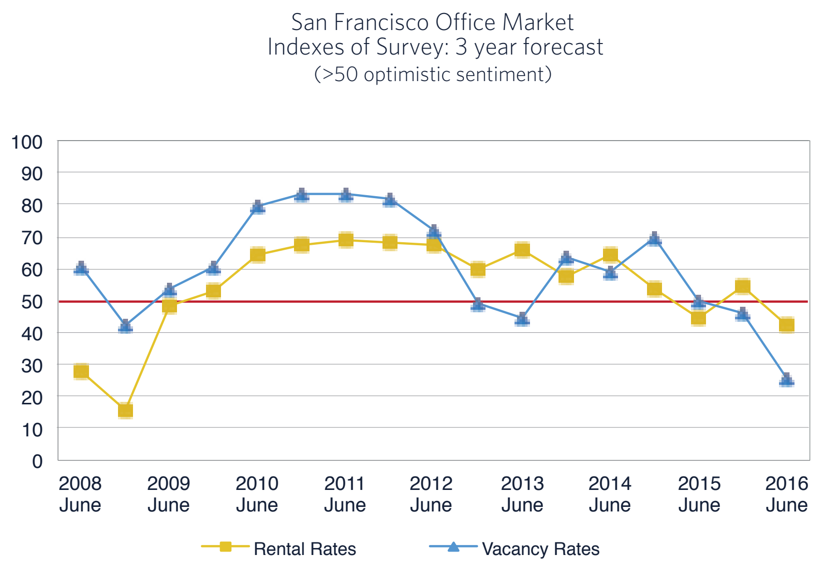
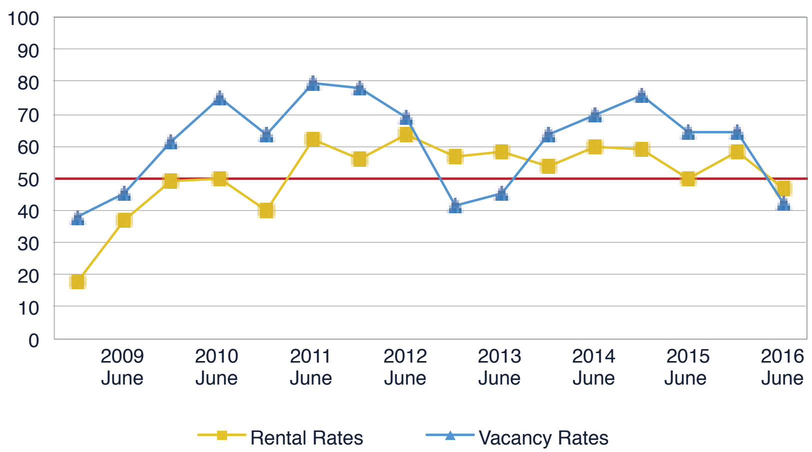
2013 June
2014 June
2015 June
2016 June
Rental Rates
Vacancy Rates

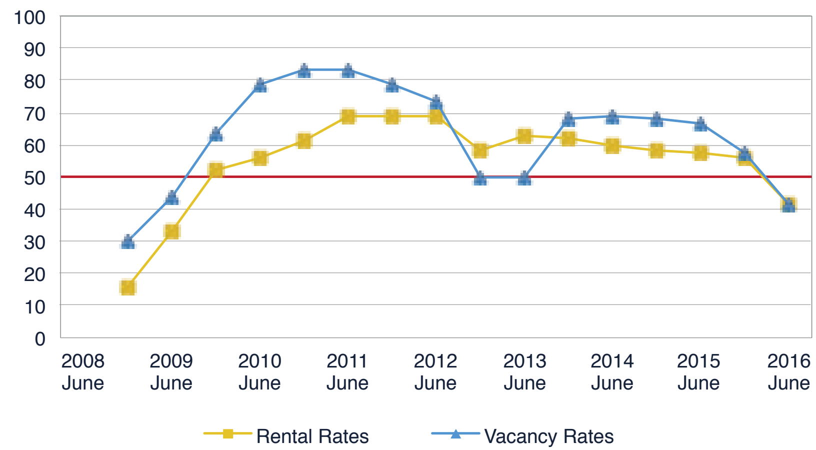

Orange County Office Market
Indexes of Survey: 3 year forecast
(>50 optimistic sentiment)
100
90
80
70
60
50
40
30
20
10
0
2007 June
2008 June
2009 June
2010 June
2011 June
2012 June
2013 June
2014 June
2015 June
2016 June
Rental Rates
Vacancy Rates


San Francisco Office Market
Indexes of Survey: 3 year forecast
(>50 optimistic sentiment)
100
90
80
70
60
50
40
30
20
10
0
2008 June
2009 June
2010 June
2011 June
2012 June
2013 June
2014 June
2015 June
2016 June
Rental Rates
Vacancy Rates

East Bay Office Market
Indexes of Survey: 3 year forecast
(<50 market weakening, >50 market tightening)



Silicon Valley Office Market
Indexes of Survey: 3 year forecast
(<50 market weakening, >50 market tightening)



The latest survey presages a new topping out of the market for office space. For each of the six markets surveyed, the trend in developer sentiment since the peak in the middle of 2014 has been downward. This occurs as developers become either more pessimistic about real rental rate growth, about vacancy rates or both. In this case it is both.

For the Southern California panels, sentiment slowly diminishes to levels between 50 and 60. A level of 50 indicates the panel believes markets will be no better, but no worse than today three years hence. Thus, one can say that the panels are still optimistic, but clearly that is abating. Nevertheless, the interest of the panelists in building new office space has held steady and the panelists' expectation is for more building to occur in the 2016/2017 time frame than in the past 12 months.

In the Bay Area the story is a bit different. The downward trend has moved across the 50 indicator and the San Francisco, Silicon Valley and East Bay panels all think that by 2019 real rental rates and vacancy rates will be worse than today. Panelists were most pessimistic about the San Francisco market in spite of Propositions M and C, which limit both new building and the conversion of existing B and C office space in the city.[4] While 41 percent of the panelists stated that they would begin a new project in the next 12 months, there has clearly been a shift to fewer projects.

To put this in perspective, the survey does not say construction of office space is imploding. Rather it says that one ought not expect it to be more robust in 2019 than it is today. When developers become more pessimistic, marginal projects cease to pencil out and are therefore not funded. That results in fewer new projects. The index is a leading indicator of that dynamic.

4. http://sf-planning.org/office-development-annual-limitation-program

COMMERCIAL MARKETS DEVELOPER SENTIMENT

Office | Multi-Family | Industrial | Retail

>50 INDICATES POSITIVE OUTLOOK

Arrow denotes change from last survey

Los Angeles

▼	59.46	Office
▲	62.93	Multi-Family
▼	59.12	Industrial
▼	54.26	Retail

Inland Empire

▼	59.33	Industrial

Orange County

▼	58.73	Office
▲	60.58	Multi-Family
▼	60.45	Industrial
▼	51.15	Retail

San Diego

▼	57.96	Office
▲	59.93	Multi-Family
▼	60.96	Industrial
▼	53.25	Retail

East Bay

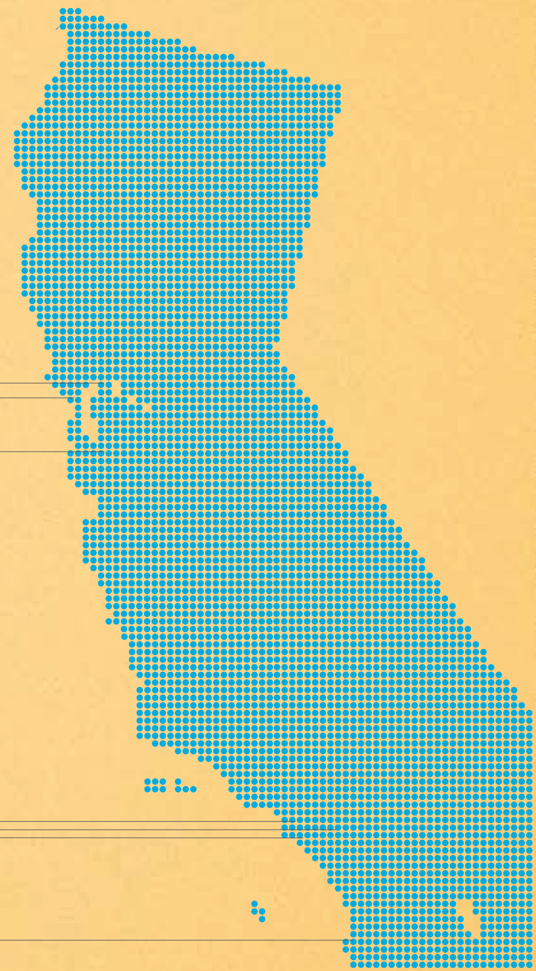
▼	44.47	Office
▼	56.52	Multi-Family
▼	54.44	Industrial
▼	53.33	Retail

San Francisco

▼	33.97	Office
▼	53.33	Multi-Family
▼	57.78	Industrial
▼	52.50	Retail

Silicon Valley

▼	41.67	Office
▼	56.11	Multi-Family
▼	59.33	Industrial
■	52.00	Retail



* Index weights have been updated

"I'm still seeing a lot of people trying to buy projects and willing to put a lot of capital into them."

- Tony Natsis,
Real Estate Department Chair,
Allen Matkins

"It's not just about doing your shopping, it's about creating a place I want to be and spend time at. "

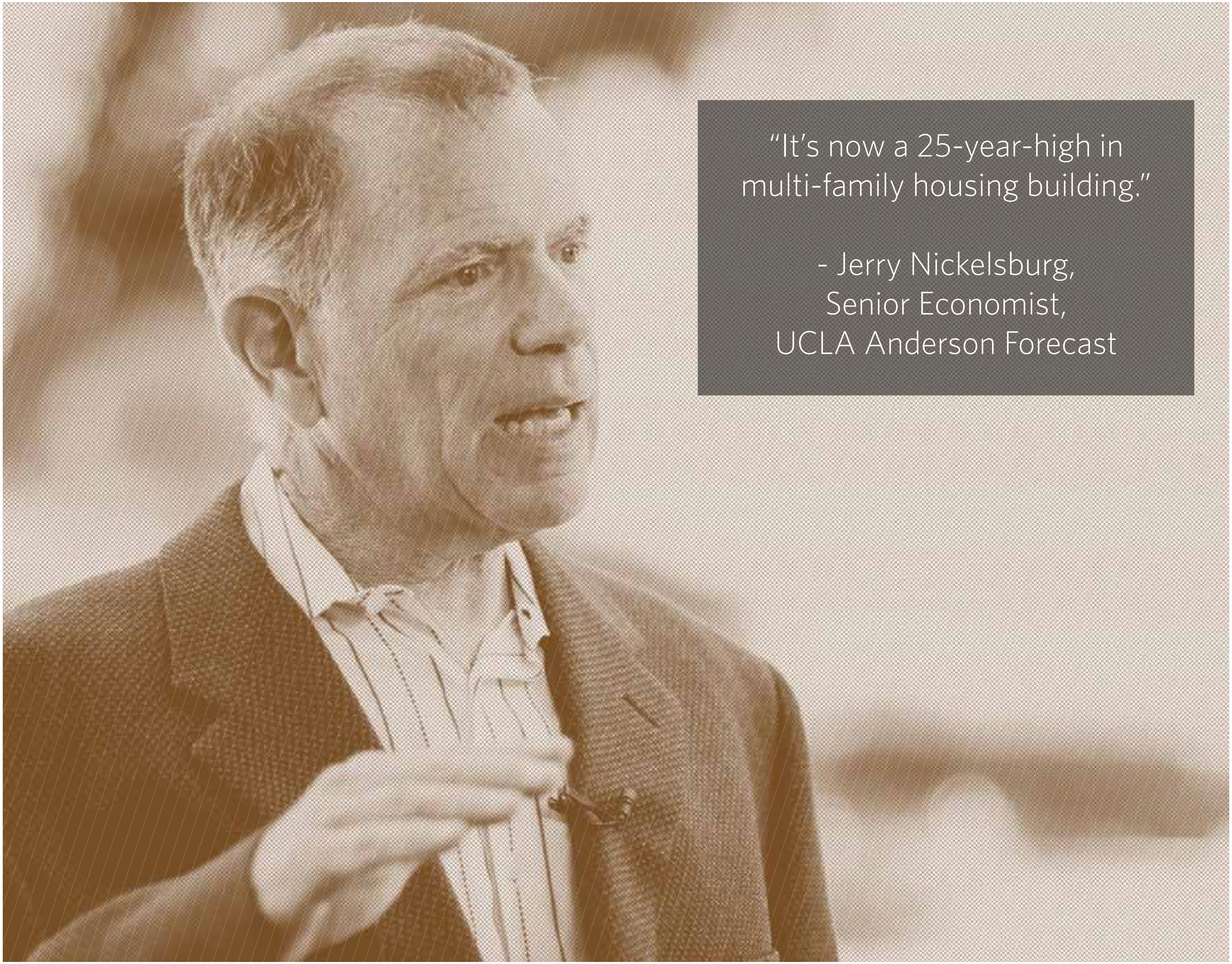
- John Tipton,
Real Estate Attorney,
Allen Matkins

"We're bullish on Downtown Los Angeles. We feel like it's starting to turn the right way, but it's been a long time coming."

- Stephen Somer,
Senior Director,
Eastdil Secured

"Millennials want to live, work, play in the same place. 10 years ago no one wanted a Starbucks downstairs. Now, it's about amenities."

- Kitty Wallace,
Executive Vice President,
Colliers International


"It's now a 25-year-high in multi-family housing building."
- Jerry Nickelsburg,
Senior Economist,
UCLA Anderson Forecast

MULTI-FAMILY MARKET

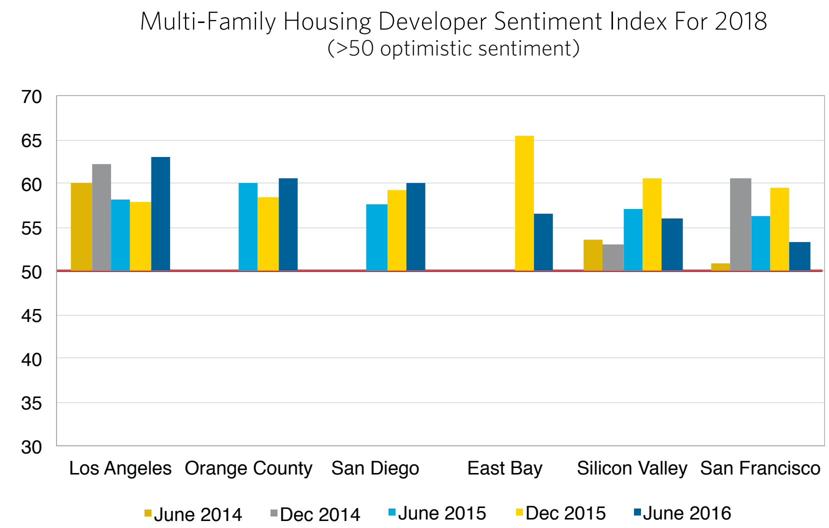
Multi-Family Residential Markets

Multi-family developer optimism has remained strong and consistent over the four years the survey has been conducted in this industry sector. The demand for multi-family housing tends to follow job growth in the more densely populated regions of California. Hence, one would expect the Silicon Valley, San Diego and San Francisco markets to tighten over the coming three years relative to Orange County. One market that is different is Los Angeles. Our Los Angeles panel expects the vacancy rate to increase over the next three years even as real rental rates continue to rise. The building of new apartments in Los Angeles is therefore expected to ease some of the shortfall in housing units, even while higher rental rates permit lessees to tolerate somewhat higher vacancies.

The East Bay market was added to the survey coverage in December. The composite index for this market is surprisingly strong given the weaker job growth in the East Bay. However, job growth in San Francisco and Silicon Valley, growth that is outstripping available housing, drives East Bay housing demand as well.

The panels continue to echo an observation made recently by the Legislative Analysts Office[5] that California housing is seriously underbuilt and that household formation is happening faster than new building. This positive view of the future of multi-family housing market fundamentals for investors is expected to continue as employment in California is forecast to grow at a 1.8 percent rate through 2017. Such growth will be skewed towards the six major coastal communities. Increased employment translates directly into new household formation and additional demands for housing.

The story of the current economic expansion has been a shift in tastes from single-family housing with concommitant commuting into the employment centers to a balanced mix between single-family and multi-family housing. Though overall residential construction has remained at depressed levels in the State, multi-family construction has rebounded sharply. Two years ago the number of multi-family permits issued in the state per month rose to pre-recession levels. The forecast for higher rents and continued low vacancy rates should induce a further increase in multi-family construction. Consistent with this, the UCLA Anderson Forecast indicators for multi-family construction is for a 25-year high to be reached during the next three years. Unlike office space, there is no evidence of a cooling in the construction of multi-family housing.



5. *"California's High Housing Costs: Causes and Consequences," March 2015. http://lao.ca.gov*


“We’re in a very dynamic transition for industrial warehousing and manufacturing.”
- Darla Longo,
Vice Chairman,
CBRE

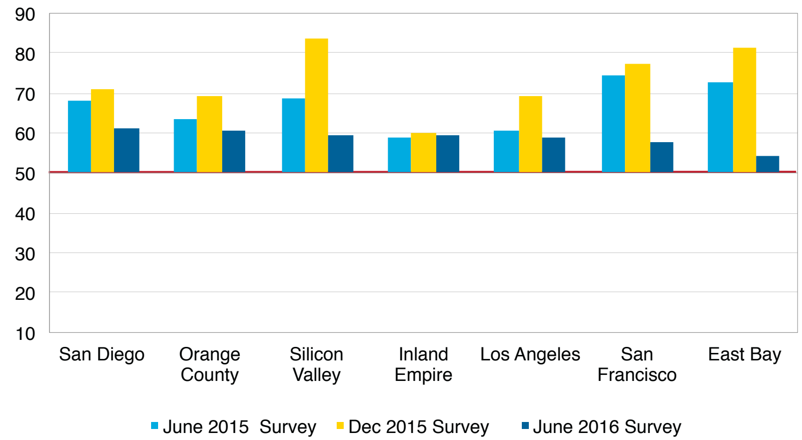
INDUSTRIAL MARKET

Industrial Space Markets

Industrial Space is comprised of two distinct markets: manufacturing and warehousing. Although each geography surveyed has a mixture of both, Silicon Valley, Orange County and San Diego County can be broadly characterized as being more heavily manufacturing, Los Angeles and the East Bay a mix of the two, and San Francisco and the Inland Empire by warehousing. The basic underlying economic forces driving the demand for industrial space in California are manufacturing, the export of goods to Asia and Mexico, U.S. importation of consumer goods from the manufacturing centers of Asia transiting through California's ports, and of increasing importance, e-commerce.

The current Survey of industrial space developers indicates little change in sentiment compared to last year. Industrial markets, particularly the warehouse segment, remain on fire. The latest retail sales numbers are consistent with our panels' views. In short, retail's bane is industrial's gain. This optimism, expressed in each of the markets surveyed, continues to be manifested in new building. With extremely low vacancy rates at present and an optimistic view by developers the building boom should continue through at least 2019.

Industrial Space Developer Sentiment Index For 2018
(>50 optimistic)



"Brick and mortar retail isn't going away, but online and e-commerce has caused many traditional retail formats to reinvent themselves."

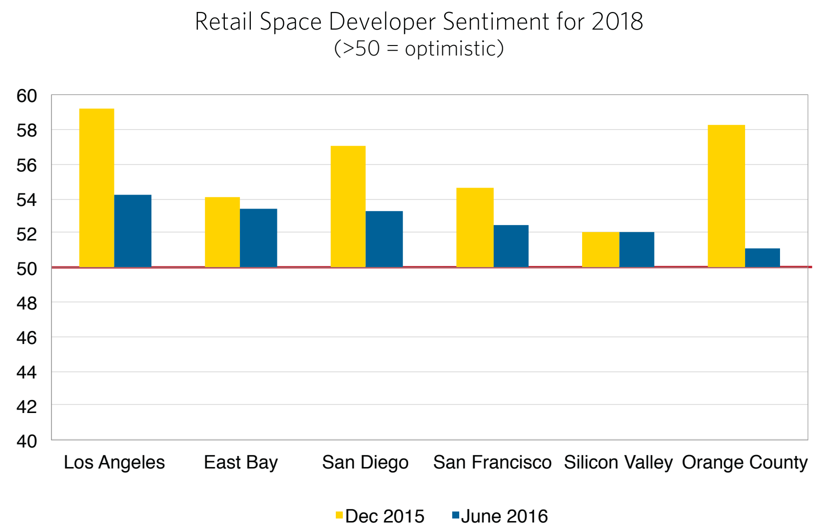
- Rhonda Diaz Caldewey,
Managing Director,
Cushman & Wakefield

RETAIL SPACE MARKETS

As of last December the Retail Market Developer Sentiment Survey included all six major California markets. Although there are few observations, some reflections on the data can be made. Part of the difficulty associated with inferences in the retail sector is the fact that retail is undergoing a profound change from distribution conduits to experience-shopping venues.

Though there are no reference points from which to judge these early survey results, in each of the six markets polled sentiment with respect to retail space was positive. Nevertheless, there has been a falloff between the December and June surveys. That sentiment is weakening is an indication that at least some of the panel is now taking a more pessimistic view of retail markets going forward. Though new construction of retail space to support the booming multi-family market and renovations of existing high quality malls to change them from existing brick-and-mortar stores to experience venues appears to be driving retail, there are significant headwinds as consumers shift to online purchases.

However, in Southern California about half of the panelists, and in the Bay Area nearly two-thirds of the panelists, stated that they were planning new retail construction in the coming 12 months and half stated that they had begun at least one new project in the past 12 months. This suggests although the retail space maybe struggling in general there remain significant opportunities, at least in the realm of retail space construction. The trends pointed out in Dr. Shulman's article[6] and reflected in the latest UCLA Anderson Forecast[7] suggest this is a short-lived transitional boost to construction and future survey results ought to predict a topping out in retail construction.



A Broad-Based Recovery

The Allen Matkins/UCLA Anderson Forecast Survey was designed in 2006 as a vehicle for improving forecasts of the evolution of commercial real estate markets. Although the Survey still remains quite new, there is now enough data for inferences with regard to turning points in office and industrial spaces and interpretations of all four types of commercial real estate of the snapshots provided by each new Survey. Importantly, the Survey indices are providing an early warning of significant changes in non-residential construction activity.

The optimism about 2019 in the Surveys with respect to multi-family housing and industrial space, broad based across all markets, is an important indicator of both the probability of new additions to stock being started over the next three years and of opportunities for new investment. This optimism, supported by job and income growth on the demand side and a lack of sufficient building on the supply side reflects what we expect, a continuation of the growth of these types of non-residential construction at or above previous peak levels. The less optimistic and pessimistic signals in office space and retail markets, while indicators of topping out, do not spell doom and gloom for the markets per-se. Absent a recession, the pull back in office and retail construction ought not correspond to a collapse in values. The risks to this outlook are contagion in financial from the nascent re-valuation of tech start-up companies and a downturn in consumer attitudes engendered by an increasingly volatile world. Nevertheless the UCLA Anderson Forecast sees the most likely outlook for the economy, and therefore for commercial real estate to be consistent with the developer sentiment reported herein.

6. *David Shulman, "Letting the Air out of the Commercial Real Estate Balloon," Ziman Economic Letters, (forthcoming) 2016.*
7. *UCLA Anderson Forecast, June, 2016.*

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