East Bay

Los Angeles

Orange County

San Diego

San Francisco

Silicon Valley

Inland Empire

Winter/Spring 2011

ALLEN MATKINS/UCLA ANDERSON FORECAST

CALIFORNIA COMMERCIAL REAL ESTATE SURVEY

Allen Matkins

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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 eighth 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.

John M. Tipton

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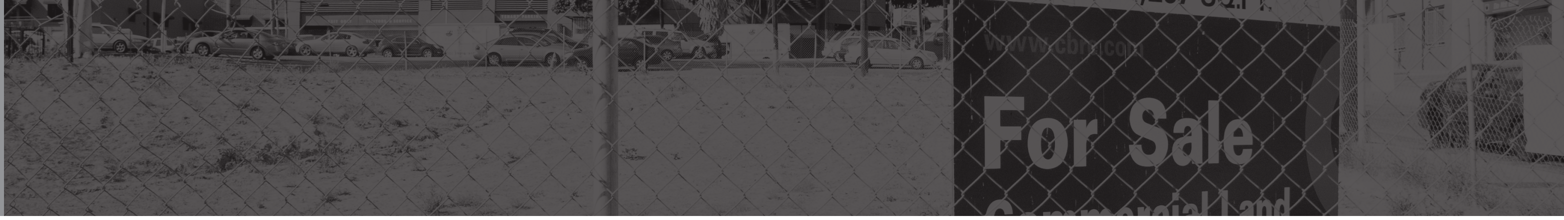
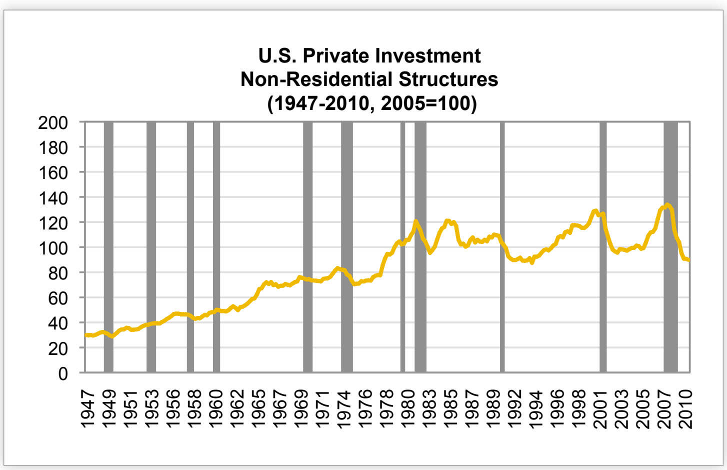


California Office and Industrial Markets: Images of the Recovery

Jerry Nickelsburg
Senior Economist

This report on the December 2010 Allen Matkins / UCLA Anderson Forecast Commercial Real Estate Survey is entitled “Images of the Recovery,” yet California commercial real estate markets have shown virtually no sign of improvement in the six months since our last survey. Indeed, some markets look worse than before. Overall, construction has diminished, vacancies have risen and rental rates have fallen. Permits for new building increased slightly in Orange County and San Francisco, and fell from low to virtually zero in most other markets.

Nevertheless, the contraction is slowing and in the latest survey there are signs of real optimism. In June, the survey picked up the first indication of a turning point in the latter part of 2012 or early part of 2013. The current survey, taken in November and December 2010, bolsters those results and gives us more confidence that we are looking at the image of a turning point.



How do we reconcile the current market data with the Survey Panel’s optimism? First, the current malaise in commercial real estate markets in California is not surprising. A recovery in commercial real estate always lags a recovery in the rest of the economy. What we are observing is typical in this part of the business cycle. Historically, the decline in non-residential construction happens over a two year period following the onset of a recession. After the recession shake-out, there is a hiatus in activity followed by a recovery. The length of the hiatus, however, is variable. In the ’69, ’90 and ’01 recessions the recovery in commercial real estate markets was quite slow, and after the other post World War II recessions building began within 24 months. In all cases though, a recovery was initiated by a change in developer expectations. As expectations change from pessimism to optimism, developers begin the several year-long process of preparation for new projects. So, initial developer activity occurring while markets are stagnant becomes the first image of a recovery.

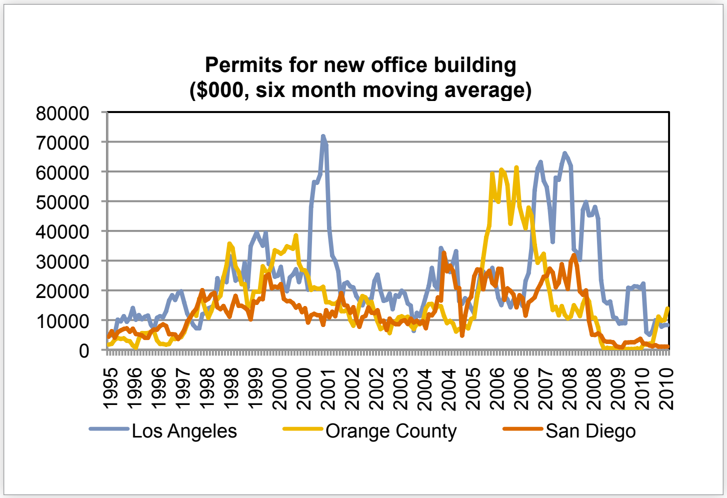
The Allen Matkins UCLA Anderson Forecast Survey and Index project compiles the views of commercial real estate developers with respect to markets three years hence. Their sentiment is a good indicator of current developer expectations and future market activity as three years is the average decision window for the bulk of large commercial projects. Developer expectations, captured by the December 2010 survey, are a clear signal of light at the end of the tunnel. 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[1].

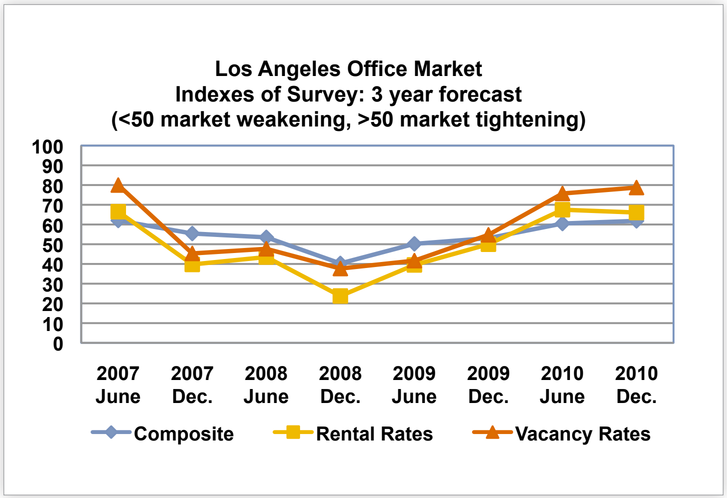
Southern California Office Markets

In Southern California, owners of office space continue to suffer the ill effects of both the 2008/2009 recession and the ever so slow 2009/2010 recovery. As office using employment shrunk during the recession, hundreds of thousands of square footage was returned to the market. The economic recovery, which began 18 months ago, has produced some, but not much, job gain[2]. From a market perspective though, the demand for office space has fallen as firms across the Southland finish existing leases and negotiate for a smaller office footprint[3].

Consequently, there is a continued deterioration of office markets in Los Angeles, Orange, and San Diego counties and the prospects for significant change in the next twelve months are not good[4]. However, we find a very different picture than one might glean from the current market stress the following twelve months. The optimism which we observed in our mid-2010 survey has been buoyed by events over the last six months and from the perspective of our panel of experts, today's low and falling rental rates and high and climbing vacancy rates will be reversed over the next two years and there will be a return to more normal markets.

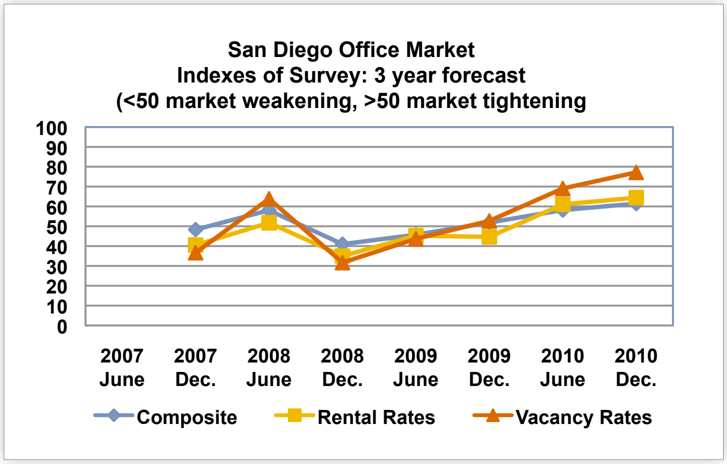
New building in Los Angeles and San Diego began to fall sharply in 2008 and reached fifteen year lows early last year. Substantial job losses in finance and professional and business services, heavy users of office space, caused a drop in occupancy rates and a drop in the utilization of "occupied" leased space. But neither market was overbuilt during the last expansion. 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, today's paucity of new construction combined with an increasing demand for space will absorb the current excess supply and ultimately firm the L.A. and San Diego Markets office markets.

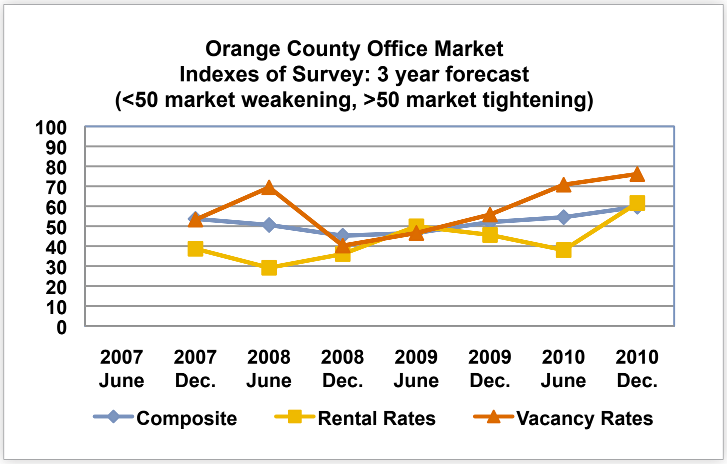




For Los Angeles and San Diego, the index increased to its highest level since the survey began in June 2007 indicating optimism with respect to both rental rates and occupancy rates. As compared to the June survey, the panel is now more optimistic with regard to both building conditions for new office space and overall vacancy rates. This suggests that something closer to 12% rather than 20% vacancy rates is in the not too distant future. In short, the story for the Los Angeles and San Diego County markets is that the current malaise is playing itself out. The Anderson Forecast for office-using employment is consistent with this view. By the middle of 2011 the demand for office space should begin to turn around and the excess office space currently on the market should be absorbed through 2012.

For Orange County, developer sentiment has moved from pessimism to optimism over the last six months. 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[5]. Because these jobs are not coming back, this created a big employment hole for the Orange County economy to fill. Given the sub-prime implosion, the Orange County market was overbuilt. Absorption of the excess supply requires a greater than average expansion in other sectors. This process takes, on average, about seven years. Orange County is now four years into the seven and the developer sentiment, looking three years ahead to the end of the structural adjustment, has changed reflecting tangible progress in this regard. The Orange County economy has benefited from the growth in exports of technology intensive goods and professional services over the past eighteen months and office markets are finally showing some signs of stabilization. Thus, relative to today, the panel sees 2013 as having higher occupancy and rental rates, and overall, more favorable conditions for office space development.





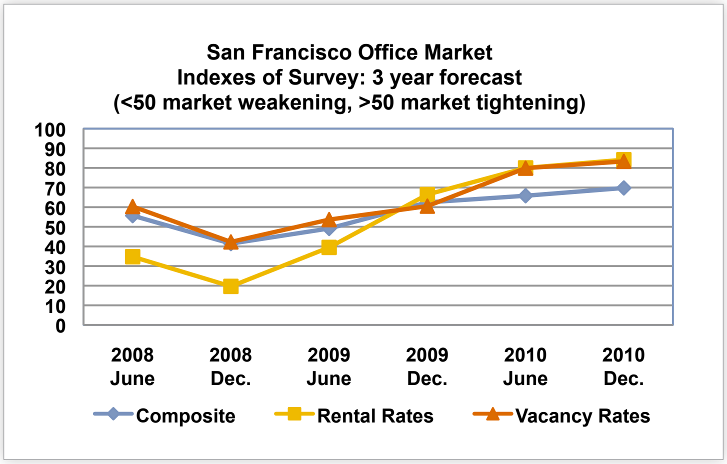
Bay Area Office Markets

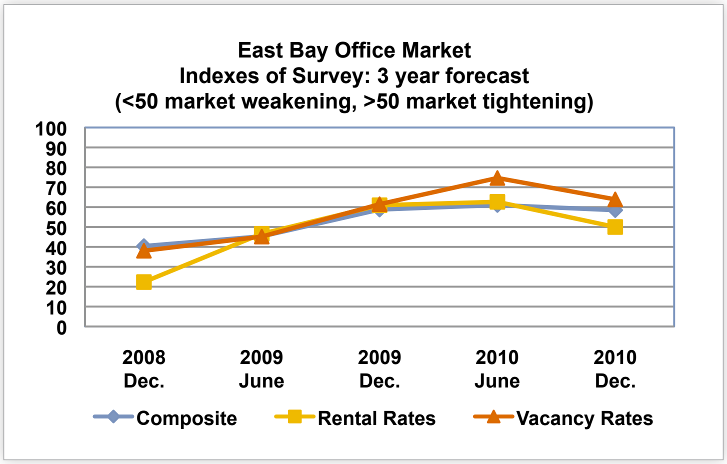
The boomlette in new office space construction that San Francisco and Silicon Valley experienced at the peak of the market in 2008 resulted in the two sub-regions exiting the recession with significant excess supply[6]. As a consequence, construction has returned to the near zero levels of the early part of the last decade[7]. The current state of the Bay Area office market, as in the rest of California, is characterized by falling rental rates, vacancy rates in the mid to high teens, and little new construction activity[8]. Still, recent, albeit jobless, economic growth in the Bay Area portends improving markets, and our Bay Area Office Market Survey is showing us images of a recovery in Bay Area Markets.

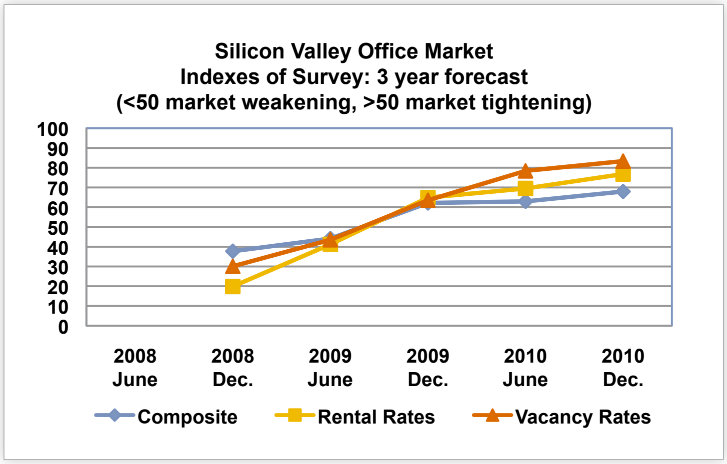
Three important characteristics of this recovery are the Increase in exports, particularly to the fast growing economies of Asia, a turn-around in business investment in equipment and software, and state and national policies to induce green tech investment[9]. These aspects of the incipient recovery are being felt in the Bay Area's technology sector and there is some anecdotal evidence of a need for more office space[10]. Even though the tech and finance sectors in San Francisco and Silicon Valley suffered job loss in the downturn, there was not the same evaporation of an entire industry as in Orange County in 2006/2007 or in the Bay Area at the early part of the last decade. Therefore, a normal recovery will absorb existing space and begin to drive new office construction.

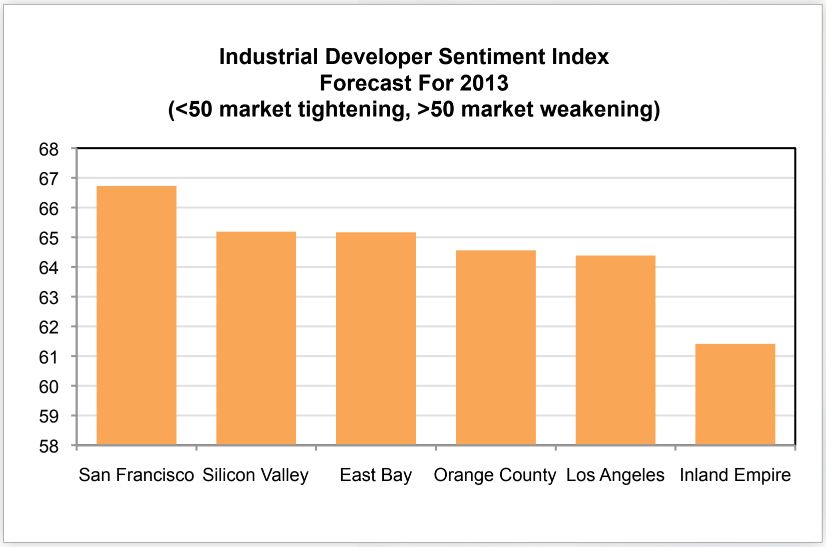
The East Bay outlook is not as optimistic. East Bay demand for commercial real estate depends not only on local demand, but also on the rent gradient from the other side of the Bay. Moreover, the East Bay office space footprint prior to the recession had significant finance, logistics, and government components. With rents in San Francisco and Silicon Valley relatively low, and a sluggish East Bay economic recovery, the resurgence in office space demand in other parts of the bay will not arrive as soon or with as much strength as in other parts of the Bay Area.

The Bay Area Developer Panel is now strongly optimistic with regard to San Francisco and Silicon Valley. They see rental and occupancy rates increasing sharply in the next two to three years as increased demand for technology and software push up employment in office using fields. In the East Bay the Panel's optimism waned from June to December. While it is difficult to pinpoint why developers are less enthusiastic, it may be in part related to the revelation of a greater state budget deficit. State and local government are heavy users of East Bay office space and an austere state budget will negatively affect East Bay office demand.








Industrial Developer Sentiment Index
Forecast For 2013
(<50 market tightening, >50 market weakening)
68
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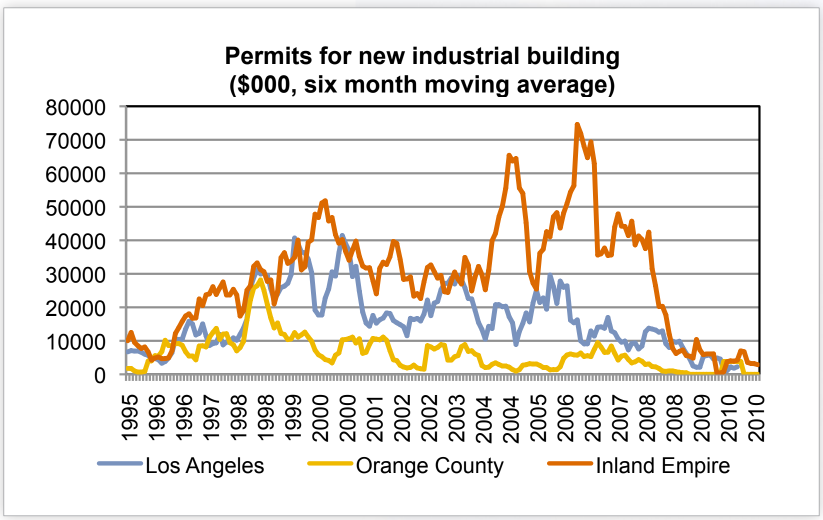
San Francisco
Silicon Valley
East Bay
Orange County
Los Angeles
Inland Empire


Permits for new industrial building
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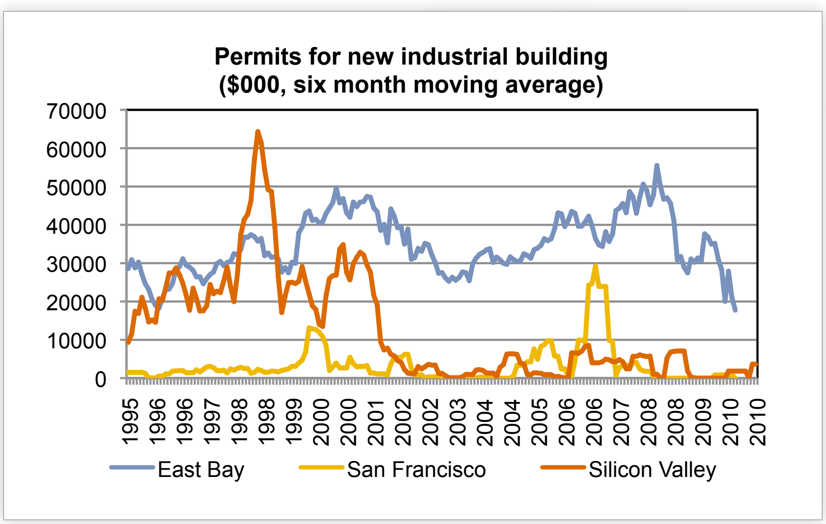
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East Bay
San Francisco
Silicon Valley

California Industrial Space Markets

Construction of warehouses and factories has ground to a virtual halt everywhere in California. The growth in exports, increased demand for electronics, computers and software, and increased consumption of goods manufactured in Asia has yet to provide enough optimism about 2011 to engender new building.

The Allen Matkins / UCLA Anderson Forecast Industrial Space Survey and Index Project is now beginning its second year. The current survey finds developers in the Bay Area more optimistic about the future of manufacturing and warehouse space. The Bay Area is a major center for exports, and this is shaping up to be an export led recovery. It is also a prime sub-region for investment in green tech, electric automobile and electricity storage manufacturing, and computers and information systems. Even though ample space currently exists in the Bay Area, the current growth in output is consistent with our panel's view, and their improved expectation for strong markets in 2013.

In Southern California warehouses to store and distribute imported manufactured goods from Asia are an important component of industrial space supply. The weak U.S. consumer recovery has translated into somewhat more subdued optimism with regard to factories and warehouses. This is particularly true with regard to the Inland Empire. The panel's outlook for industrial space in Los Angeles and Orange County, producers of information, medical technology, pharmaceuticals, aerospace components and computers and electronics, is one of optimism, though not with the same enthusiasm as in the Bay Area. Nevertheless, the expectation of improved industrial markets in 2013, even in the Inland Empire, is another image of a recovery on the way.

The Light at the End of the Tunnel is Still On

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 first appeared last June and 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 have now seen six months of optimism. This is consistent with the historical pattern of recovery in commercial real estate markets lagging a recession by two to three years. The depth of the recession and the slowness of the recovery attenuate the recovery in commercial real estate markets, but the evidence from the Surveys indicates that the historical pattern will hold. In sum, the continued optimism is a solid image of a turning point in commercial markets by 2013.

■

1. 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.
2. http://www.labormarketinfo.edd.ca.gov
3. See for example, Robert Faturechi, "Office Buildings With the Highest Vacancy Rates, "Los Angeles Times January 24, 2010.
4. Lou Hirsch, "The Pulse of Commercial Space is Stabilizing," San Diego Business Journal, January 3, 2011.
Richard Clough, "Enthusiasm Fades in L.A. Office Market," Los Angeles Business Journal, October 18, 2010.
"USC Casden Economic Forecast; Office and Industrial Markets," USC Lusk Center, December 10, 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. Dan Levy, "Silicon Valley 'bloodbath' leaves buildings empty (Update 2)," http://bloomberg.com January 5, 2010.
7. See for example: Office Market Report, Aegis Realty, http://www.aegisrealty.com/reports/AEGIS_Q1_2010.pdf
8. Alan Billingsley and Alex Symes, "2010 U.S. Real Estate Investment Outlook and Market Perspective," PREEF Research, 2010.
CB Richard Ellis, "San Francisco Bay Area Office Regional Summary," 2010.
9. UCLA Anderson Forecast, December 2010.
10. http://bayareacomre.com/2010/12/21/silicon-valley-heads-north-the-office-boom-in-sfs-soma-district/

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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 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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