

Los Angeles | Orange County | San Diego | San Francisco | East Bay | Silicon Valley | Inland Empire



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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

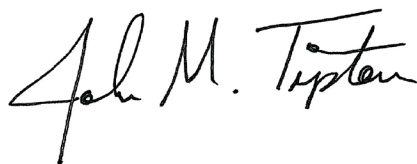
Allen Matkins and UCLA Anderson Forecast have partnered to create a Commercial Real Estate Survey and Index to better predict future California commercial rental and vacancy rates. This tool surveys supply-side participants – commercial developers and financiers of commercial development – for insights 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, industrial and multi-family space in major California geographical markets. This twelfth survey covers the major Southern California and Bay Area markets for office, industrial 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, 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 60 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 Commercial Real Estate Markets: Cautious Optimism

William Yu
Economist

The Winter/Spring 2013 Allen Matkins / UCLAAnderson Forecast Commercial Real Estate Survey (CRES) indicates that the three-year-ahead¹ outlook for the office, industrial, and multi-family markets in California continues to be optimistic. However, all office markets show a receding strength of optimistic sentiments. Why? There are four possible reasons.

First, the CRES was conducted in November, 2012, a month in which policy uncertainty was rising² because of the anguish over the “fiscal cliff.” The fear could suppress the developers’ optimism to some degree. Second, the Federal Reserve’s zero interest rate policy is expected to be lifted in 2015.³ As a result, the expected monetary tightening in 2015 will put a brake on resurgent office markets. Third, as mentioned by UCLAAnderson Forecast Senior Economist David Shulman in his article, “An Uneasy Look at Office Space Demand⁴,” a reduction in space per worker has been taking place and will persist into the future driven by improving technology and rising costs. This downsizing effect will partly offset the increased demand for office space induced by the employment growth of the office-intensive sectors. And finally, the optimism we have seen reflected in the past year’s surveys has driven new building plans, which tend to meet some of the anticipated supply requirements for 2015.

While there is some truth to all four reasons, we should make no mistake in the interpretation of the survey: the CRES still

predicts that the commercial markets will remain resilient for the following three years in California coastal metro areas because all the composite indices have been above 50 for the past three years. Nevertheless, the CRES signals that office developers are cautiously optimistic in 2015 and beyond.

California Office Space Markets

The Winter/Spring 2013 CRES covers six office space markets in California. As shown in Figure 1, San Francisco has the highest composite sentiment index of 62. Silicon Valley and Orange County have the next highest index of 61. San Diego holds the fourth position with 59, Los Angeles and The East Bay follow with 57 and 56 respectively. All of these index levels are above 50 and therefore are representative of an optimistic sentiment among developers.

Has the CRES been successful in forecasting the realized office markets? In retrospect, the record is reassuring. For example, these six office markets’ in Figure 1 indicated a turn-around of sentiments between December 2008 and June 2009, the abyss of the financial crisis. The indices projected that office markets would be expected to turn around by the end of the three-year horizon, 2011. According to Reis’s national data, the office vacancy rate did indeed start to decline slowly in 2011.

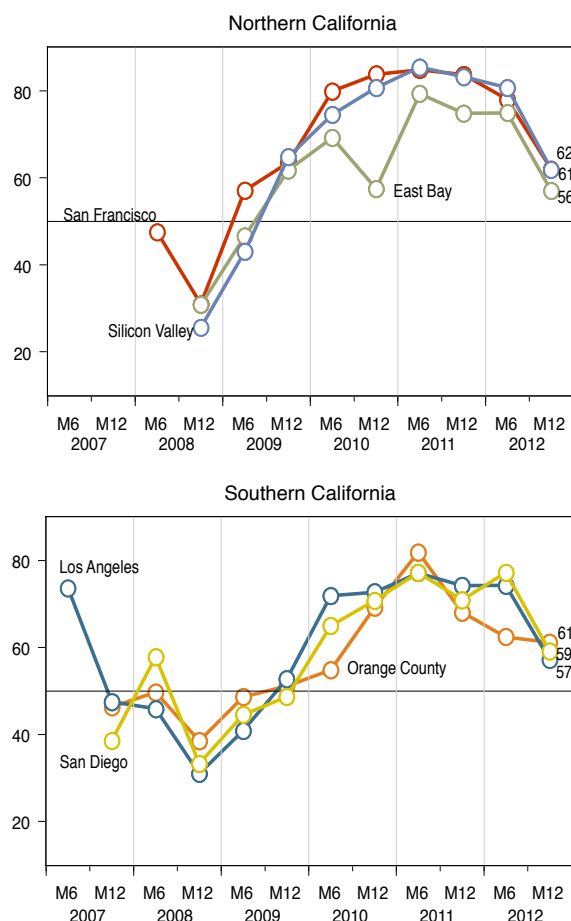
Second, from a cross-sectional perspective, the CRES proves to be a robust indicator. As shown in Table 1, the average 2009/2010 CRES Office Space Sentiment indices in San Francisco, Los Angeles, San Diego, and Orange County are 72, 62, 57, and 53, respectively. In other words, the CRES predicted that the office market in San Francisco would do better than Los Angeles, then San Diego, and then Orange County. Indeed, based on Reis's actual office vacancy rate in Q3 2012, San Francisco, Los Angeles, San Diego, and Orange County's vacancy rates are 13.3%, 15.2%, 16.8%, and 19%, respectively.

Therefore, according to our latest CRES results in Figure 1, the lower sentiment index in December 2012 predicts higher office

Figure 1.

Office Space Developer Sentiment Composite Index

(Below 50 indicates a weakening market and above 50 indicates a tightening market; the survey year predicts up to 3-year-ahead markets, e.g. 2012 predicts markets in 2015)



vacancy rates by the end of 2015. The optimistic CRES from 2010 to June 2012 projects declining office vacancy rates between now and 2015. Moreover, office markets in San Francisco and Silicon Valley will continue performing better than the other four markets.

Highlights of Winter/Spring 2013 CRES for Office Space Markets

1. The Los Angeles market sentiment for vacancy rates eases to below 50 while the rental rates decline slightly.
2. The Orange County market sentiment for vacancy rates declines slightly after dropping sharply from December 2011 to June 2012 while the rental rates increase slightly.
3. Similar to Los Angeles, the San Diego market sentiment for vacancy rates falls substantially while the rental rates decline slightly.
4. Bay Area markets also display a similar pattern as other California markets with East Bay sentiment easing a bit more than the others.
5. The UCLA Anderson Forecast for each of these regions in California over this period is for economic growth and employment growth at rates which exceed the U.S. employment growth rate. Therefore, this easing of sentiment throughout California ought to be reflective of an expectation on the part of the Survey Panelists of there being less excess demand in 2015 due to new projects just getting underway and adding space to the market. To be sure, the expectation generally remains for markets to be tightening.

California Industrial Space Markets

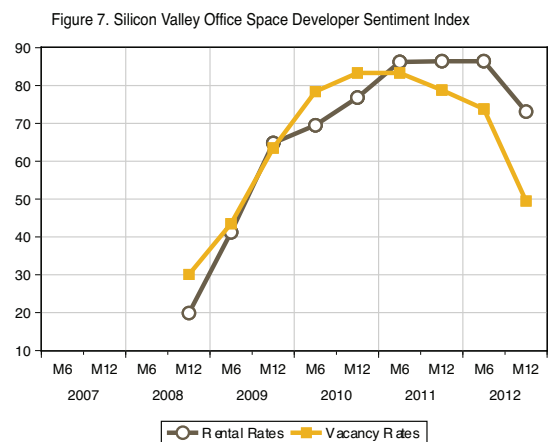
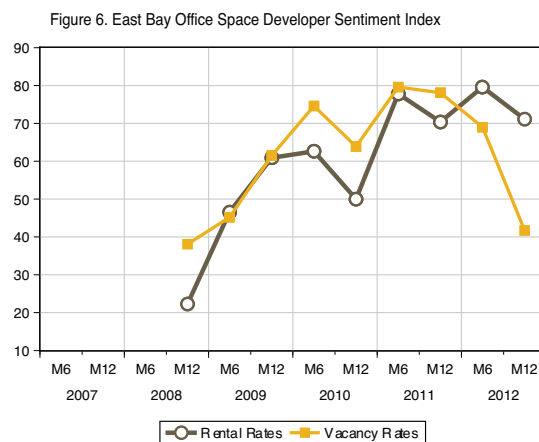
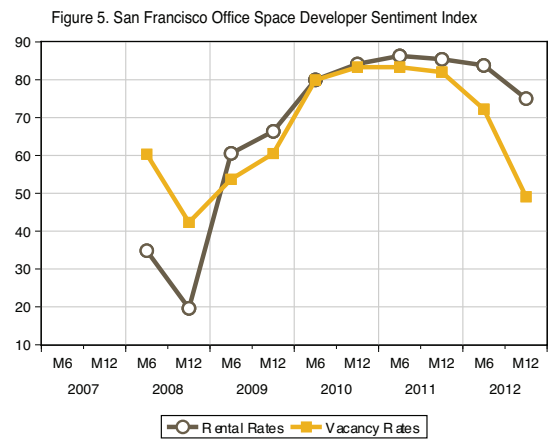
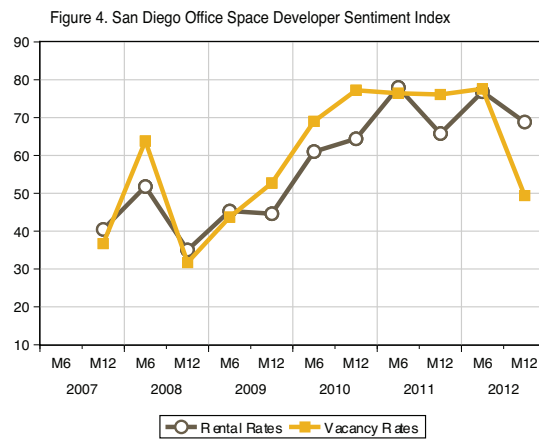
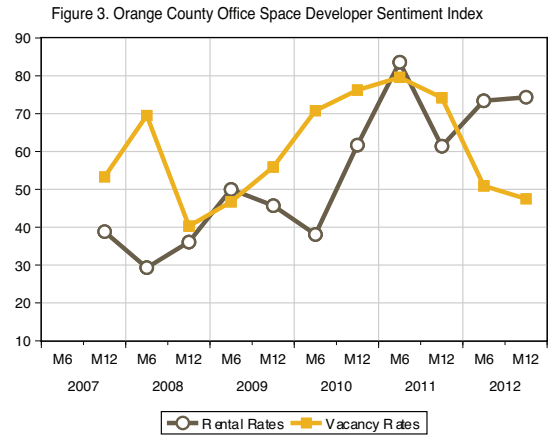
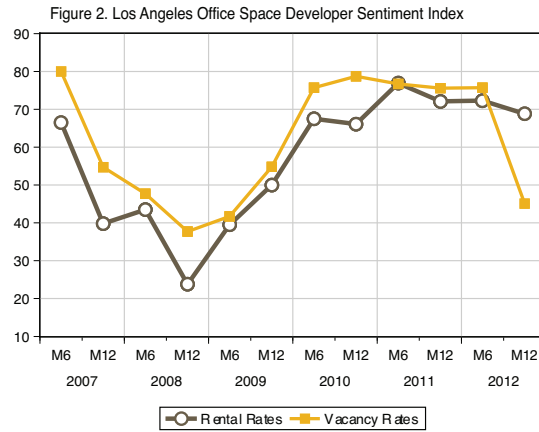
Industrial space includes two main markets: manufacturing and warehousing. As mentioned previously, Los Angeles consists of both markets. Orange County, San Francisco, East Bay and Silicon Valley are proportionately more manufacturing, while Inland Empire is proportionately more warehousing.

In general (see Figure 8), the index exhibits an optimistic outlook for 2015 with all of the composite sentiment indices well above 50. With its resilient high-tech sectors, Silicon Valley holds its superiority in the industrial space market in California with a composite index of 78, followed by Orange County (76), East Bay (75), San Francisco (74), Inland Empire (68), and Los Angeles (63).

Note that in December 2012, the CRES index turned upward for Orange County, Inland Empire, and East Bay, while Los Angeles and Silicon Valley continued their downward slides as plans for new additions to industrial space moved forward and San Francisco remained unchanged. Figures 9 to 14 show the sentiment index for both rental rates and vacancy rates of industrial space markets.

Figures 2-7.

Office Space Developer Sentiment Index



	Allen Matkins/UCLA CRES Sentiment			Actual Office Market
	2009 December Office Market	2010 June Office Market	Average between 2009 Dec and 2010 June (forecast 2012)	2012 Q3 Office Vacancy Rate
San Francisco	64	80	72	13.3%
Los Angeles	52	72	62	15.2%
San Diego	49	65	57	16.8%
Orange County	51	55	53	19.0%

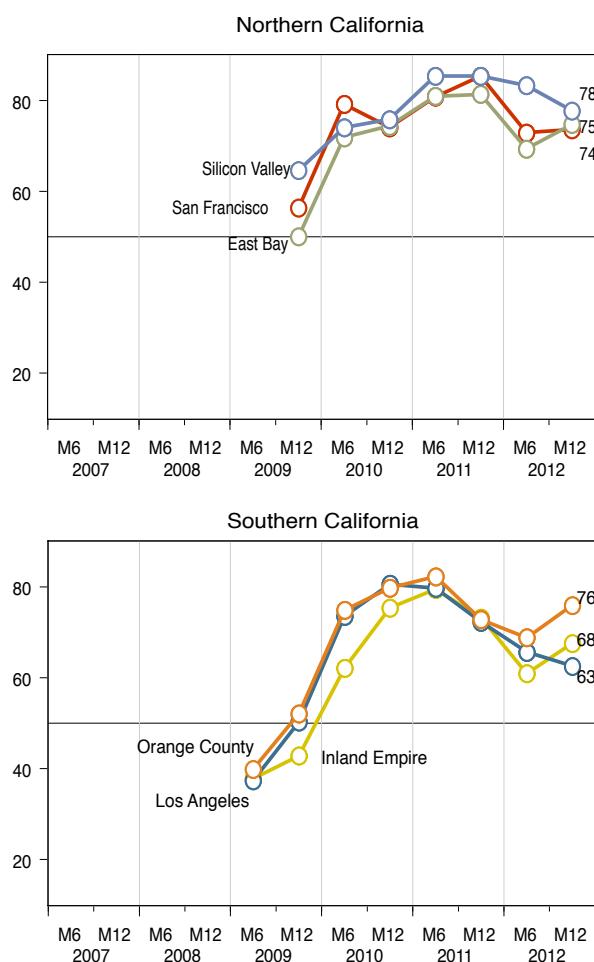
Sources: Allen Matkins/UCLA CRES Sentiment and Reis

Table 1.

Office Space Developer Sentiment Index in 2009/10 and Vacancy Rate in 2012 Q3

Figure 8. Industrial Space Developer Sentiment Composite Index

(Below 50 Indicates a weakening market and above 50 indicates a tightening market; the survey year predicts up to 3-year-ahead markets, e.g. 2012 predicts markets in 2015)



CRES and Non-Residential Investment

Figure 15 displays the nominal private gross investment⁵ in commercial buildings and industrial facilities. Non-residential investment is usually perceived as a lagging indicator compared to other economic variables. Assuming that the Los Angeles market is a fair representative of the commercial real estate market for the nation, let's examine how the CRES sentiment index lead-lag relates to the actual investment spending.

In Figure 1, the Los Angeles office sentiment index dropped to below 50 in December 2007, and in Figure 15, we see that commercial building investment started to decline in Q1 2008, suggesting that a pessimistic view is realized imminently. In contrast, in Figure 1, the Los Angeles office sentiment index came back to above 50 in December 2009, yet we did not see the commercial investment turn around until Q1 2011. This implies that an optimistic outlook takes time (12 months or so) to turn into actual construction investment. The industrial space market has a similar pattern.

California Multi-Family Housing Space Markets

The multi-family housing developers remain upbeat in Los Angeles, San Francisco, and Silicon Valley. In the aftermath of the housing bubble and financial crisis, Americans are doing three correct things: (1) reducing their private debts, (2) containing their expenditures, and (3) living closer to work, ready to relocate if needed. All of these three things are moving many Americans from single-family to multi-family homes. This is reflected in the Reis apartment vacancy rates which have declined to 4.5% (the lowest rate since 2002) in Q4 2012 from a peak of 8% in Q4 2009. Figure 16 presents the composite indices for June and December 2012. The Los Angeles sentiment index changed from 73 to 71, San Francisco from 70 to 69, and Silicon Valley from 67 to 69. None of these changes are significant and the level of optimism suggests continued investment in new multi-family housing.

Figures 9-14.

Industrial Space
Developer Sentiment
Index

Figure 9. Los Angeles Industrial Space Developer Sentiment Index

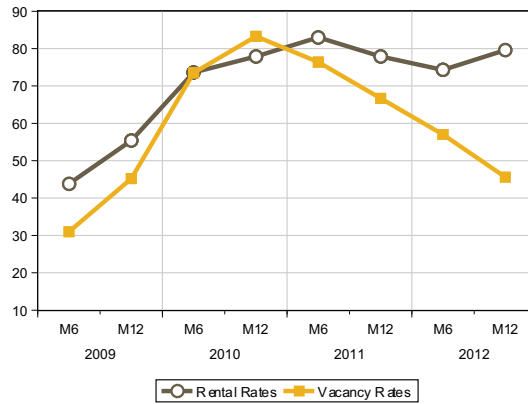


Figure 10. Orange County Industrial Space Developer Sentiment Index

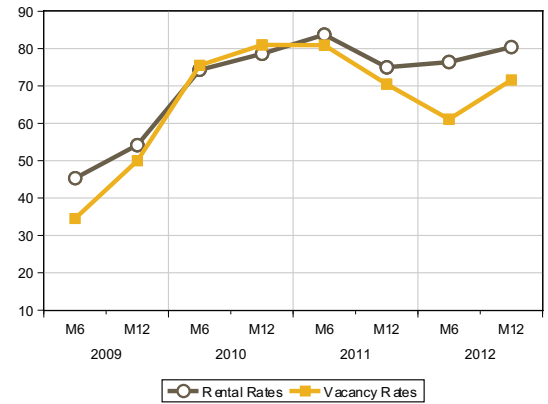


Figure 11. Inland Empire Industrial Space Developer Sentiment Index

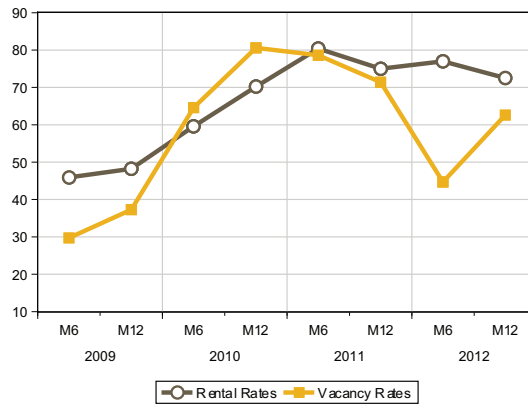


Figure 12. San Francisco Industrial Space Developer Sentiment Index

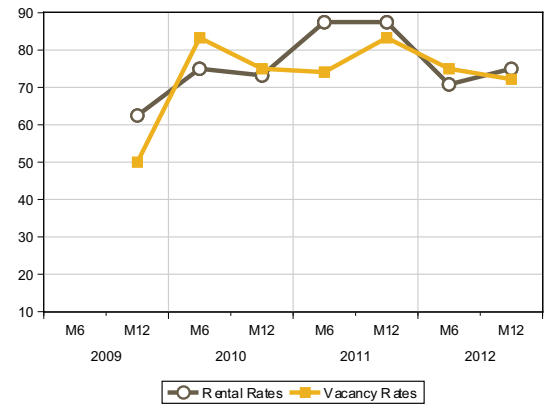


Figure 13. East Bay Industrial Space Developer Sentiment Index

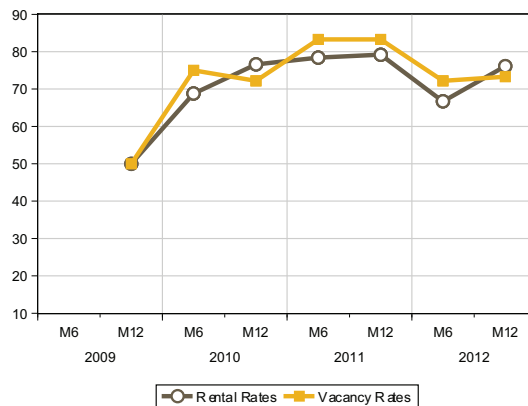


Figure 14. Silicon Valley Industrial Space Developer Sentiment Index

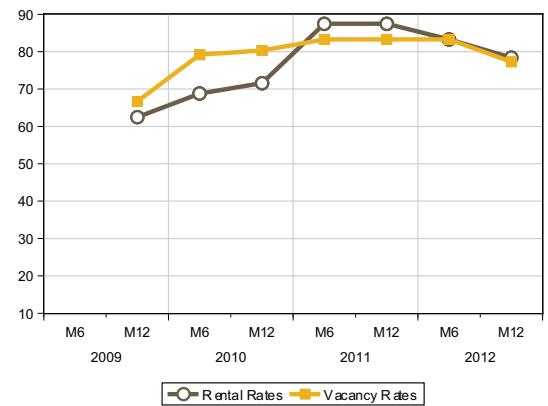
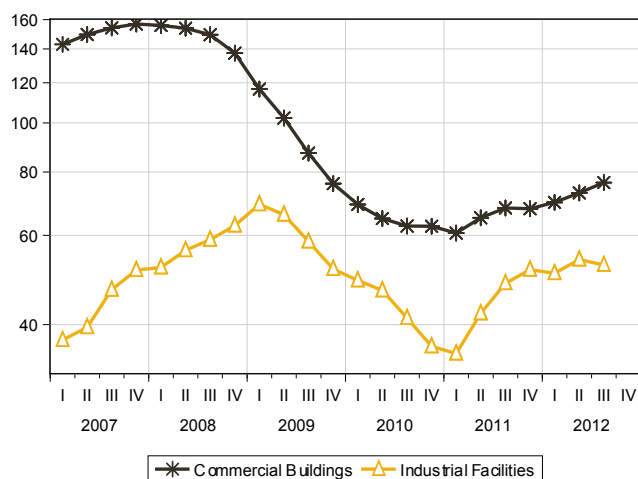


Figure 15.

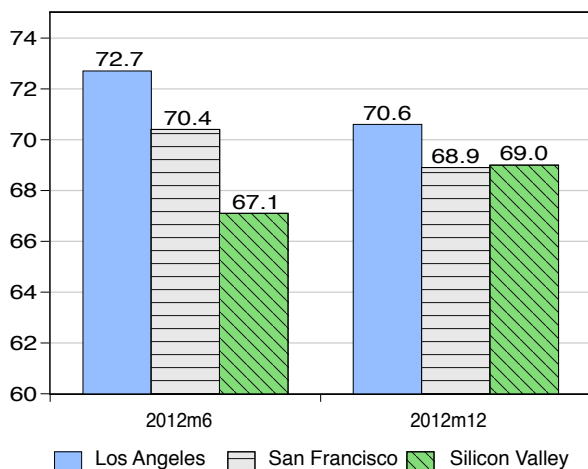
Nominal Gross Private Investment in Nonresidential Buildings in the U.S., Annualized, Billions of Dollars



Sources: Bureau of Economic Analysis and IHS Global Insight

Figure 16. Multi-Family Housing Developer Sentiment Composite Index

(Below 50 indicates a weakening market and above 50 indicates a tightening market; the survey year predicts up to 3-year-ahead markets, e.g. 2012 predicts markets in 2015)



Summary

With the U.S. economy on a path of steady recovery, the optimistic outlook for California commercial markets into 2015 reconciles the estimated business cycle ahead of us. However, due to their structural difference, we predict a recovery for California office markets with a cautious optimism. On the other hand, we forecast that multi-family housing markets will continue to thrive beyond 2015.

1. The three-year-time horizon was chosen to approximate the average time for a new commercial project to complete a development life cycle.
2. According to the U.S. Economic Policy Uncertainty Index (<http://www.policyuncertainty.com/>), the policy uncertainty reached to its highest point in November and December of 2012 before the deadline of the “fiscal cliff.”
3. From Federal Reserve Board, <http://www.federalreserve.gov/monetarypolicy/files/fomcprojtabl20121212.pdf>
4. From UCLA Economic Letter, http://www.anderson.ucla.edu/Documents/areas/ctr/ziman/UCLA%20Economic%20Letter_Shulman_12-17-12.pdf
5. The nominal and real investments during this period have a very similar pattern. For simplicity, we only show the nominal investment.

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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, founded in 1977, is a California-based law firm with approximately 220 attorneys in four major metropolitan areas of California: Los Angeles, Orange County, San Francisco and San Diego. The firm's core specialties include real estate, real estate and commercial finance, bankruptcy and creditors' rights, construction, land use, natural resources, environmental, corporate and securities, intellectual property, joint ventures, taxation, employment and labor law, and dispute resolution and litigation in all these matters. For more than 30 years, Allen Matkins has helped clients turn opportunity and challenge into success by providing practical advice, innovative solutions and valuable business opportunities. When clients' challenges require experienced trial counsel, Allen Matkins has a proven track record of successful litigation before juries, judges and arbitrators. Allen Matkins is located on the Web at www.allenmatkins.com.

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