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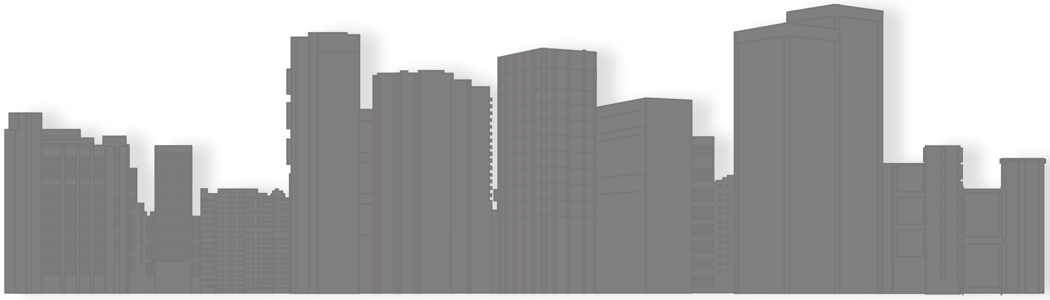

Allen Matkins | UCLA Anderson Forecast

COMMERCIAL REAL ESTATE SURVEY

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EAST BAY | SILICON VALLEY | INLAND EMPIRE

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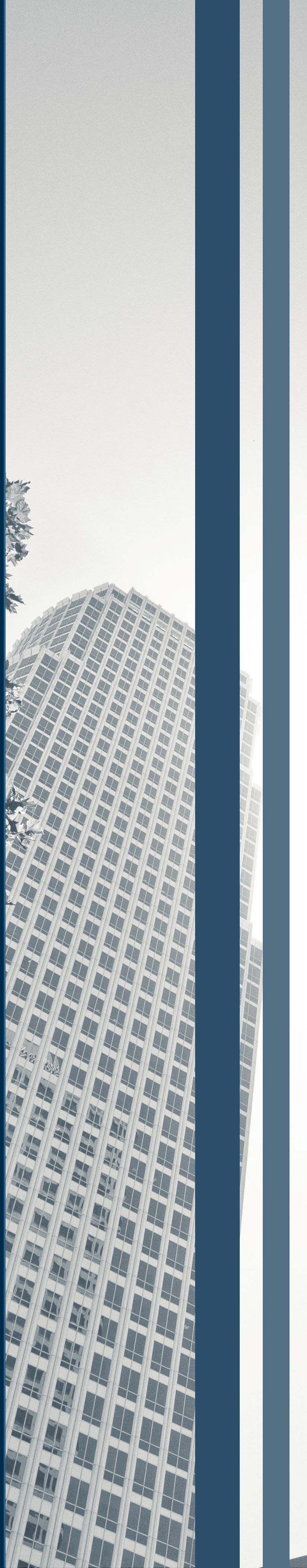

More detail on the construction and methodology behind this survey can be found in the Allen Matkins/UCLA Anderson Forecast California Commercial Real Estate Survey Support Document available at www.uclaforecast.com.

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 thirteenth 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.

John M. Tipton

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California Commercial Real Estate Survey: Towards a New Equilibrium

Jerry Nickelsburg
Senior Economist, UCLA Anderson Forecast
Adjunct Professor of Economics, UCLA Anderson School

The Allen Matkins / UCLA Anderson Forecast Commercial Real Estate Survey was initiated just before the 2008 recession. The Indexes derived from the survey were designed to provide early insight into turning points in the markets for office, industrial and multi-family space and the development of new additions to the stock of space in each market. The survey is now two for two in predicting the inflection points in each market since its inception. The initial index values predicted the turndown in commercial building prior to September 2008 and the continuation of the slump for some time thereafter. Two years before the market actually turned around, the index predicted an expansion in building. Today, 13 surveys later, there is another new prediction; that of the market coming into equilibrium.

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. 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 panel's view on occupancy and rental rates are key ingredients to their own business plans for new projects, and as such, the survey provides insight to new, not yet on the radar, building projects and is a leading indicator of future commercial construction. For example, if a developer was optimistic about the office market in Silicon Valley in 2016, then the initial work for a new project with an expected occupancy date of 2016--a business plan, preliminary architecture, and a search for financial backing-- would have to begin no later than 2013. However, the converse is not true. A developer could be optimistic about 2016 and still not find the case compelling enough to begin a new development.

Since the end of the recession we have seen developer optimism spread to all of the markets and types of commercial space we survey. Today there is the nascent recovery in new non-residential building predicted by the survey as early as 2010. The current survey, completed in May 2013, shows a new pattern of vacancy rates, that of stabilization at or slightly above current levels, and a pattern of rental rates holding their own and doing at least as well as inflation between now and 2016. This is the pattern one would expect if there were a balancing of demand and supply in the market such that neither an acceleration, nor a deceleration of the rate of non-residential construction was indicated.

CALIFORNIA OFFICE SPACE MARKETS

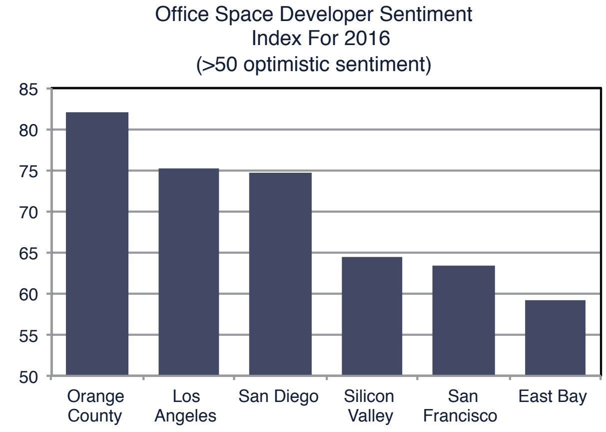
Two panels, one for The Bay Area and one for Southern California, were asked questions about the evolution of Office Markets three years hence. The highest numerical sentiment Indexes are in Orange County, Los Angeles and San Diego. This is followed by Silicon Valley, San Francisco, and The East Bay. Although each index in the survey is solidly in the optimistic zone; they no longer correlate strictly with job growth in office using employment over the past three years.[1] However, the differences in sentiment are small.

In the Bay Area Index, optimism continues to reign and the Index for each market firmed slightly. This uptick was driven by a small increase in the vacancy rate component of the index and no change in the rental rate component. Overall, the Bay Area Panel views 2016 as a year in which rental rates are going to hold up, but vacancy rates will be slightly worse than they are today.

In terms of demand and supply, firming prices (rental rates) and falling occupancy rates presents a quandary. Normally price increases and quantity decreases when there is a decrease in supply. However, in the case of long-lived assets such as office buildings, the dynamics of the leasing market are important. The building is justified based on years of leases. When a new building comes on the market, it is rational for it to be leased at an occupancy rate lower than the average in the market as the owners of the building can profit from allowing the market demand to grow into the space. This is consistent with a market where there is new construction being driven by an expanding office using economy. Interpreted this way, the survey suggests a slower but still positive growth rate of non-residential construction in 2016 and 2017 as the new office space is absorbed.

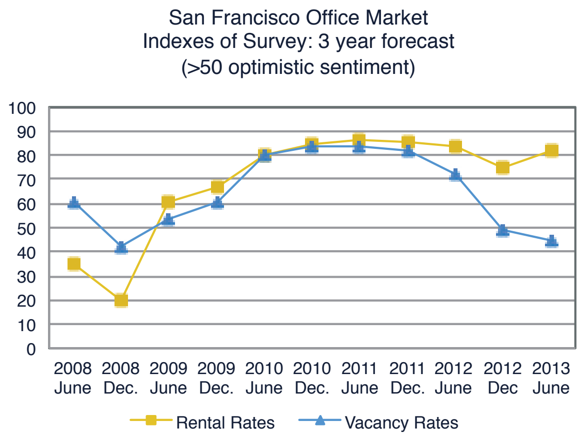
By contrast, all three Southern California Office Space Indexes firmed more sharply over the last six months. The dip in the November 2012 Office Space Sentiment Indexes in Southern California appears to be due more to concern over the Fiscal Cliff than enough new supply in the pipeline to hit an equilibrium point. As The Bay Area has been the leader in the growth of office using employment in this recovery, the fact that it is reaching an equilibrium sooner is no surprise. Nevertheless, the index is pointing to continued growth at the same or higher rates as today in office space over the next three years.

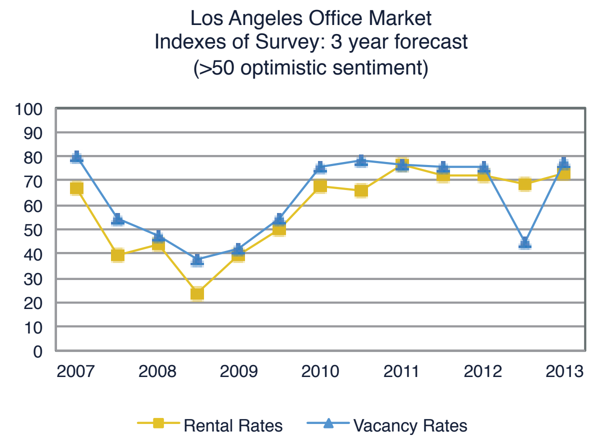
Figure 1.
Office Space Developer Sentiment Index

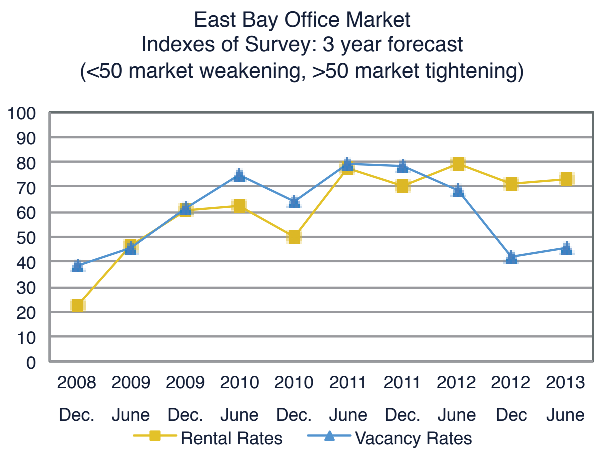


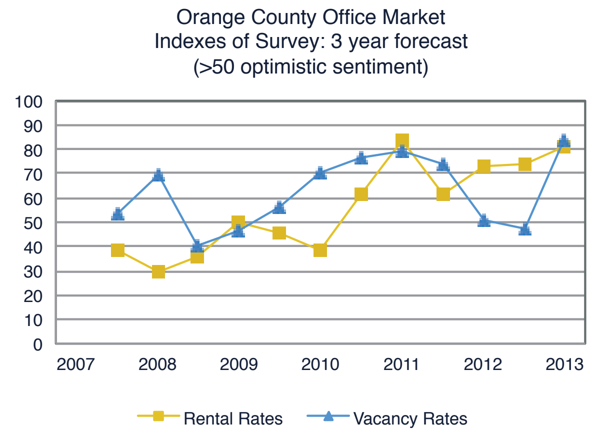
The differential in the view of the two panels is reflected in the fact that half of the Bay Area Panel will begin a new project in the coming year while only a third of the Southern California panel stated that they will do the same. With similar views of the demand North and South, but less building in the South one would expect the Southern California Panel to be less inclined to think vacancy rates would increase in 2016 relative to today.

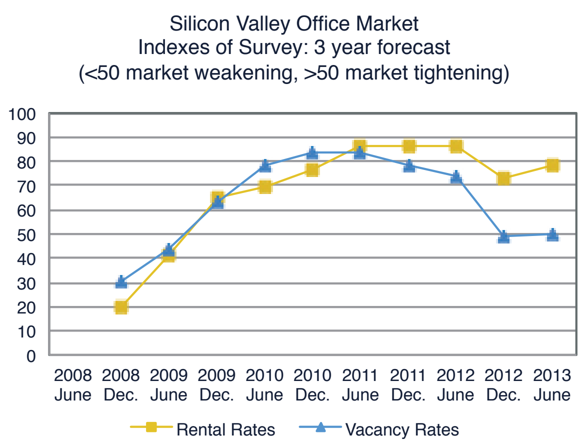
Figures 2-7.
Office Space Developer Sentiment Indices

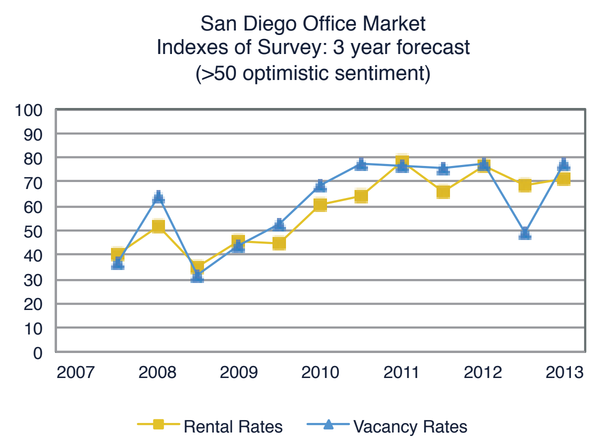












CALIFORNIA INDUSTRIAL SPACE MARKETS

Industrial Space is comprised of two distinct markets, manufacturing and warehousing. Although each geography is a mixture of both, San Francisco, Silicon Valley and Orange County can be broadly characterized as being more heavily manufacturing, the East Bay, and Los Angeles a mix of the two, and the Inland Empire by warehousing. The basic underlying economic forces in industrial markets are California manufacturing, the export of goods to Asia and Mexico, and consumer goods from the manufacturing centers of Asia brought into the U.S. through the California's ports.

The weakening of developer sentiment, first appearing six months ago, continued through the middle of this year. This positive though diminished enthusiasm is due, as with the Bay Area Office Market Index, to a view on the part of The Bay Area and Southern California panels that occupancy rates in 2016 will be lower than today. Lower occupancy and firming rental rates imply an equilibrium with new additions to the stock of warehouses and factories is keeping up with demand. It also predicts that the rate of growth in industrial space construction will slow in the 2016-17 time frame.

The issue facing developers of industrial space is the slow growth of foreign demand for U.S. goods and the frugal U.S. consumer demanding higher quality, and not increased quantity of foreign manufactured goods. Both of these translate into slow growth in the demand for industrial space on average over the coming years. That growth will require more space. Today's fundamentals have induced one half of the Southern California Panel and two thirds of the Bay Area Panel to be engaged in developing new projects. Thus, planned additions are viewed as meeting expected demand by 2016.

Figure 8.
Industrial Space Developer Sentiment Index

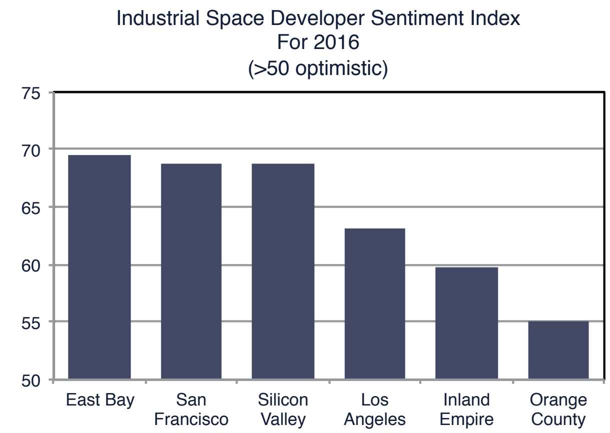
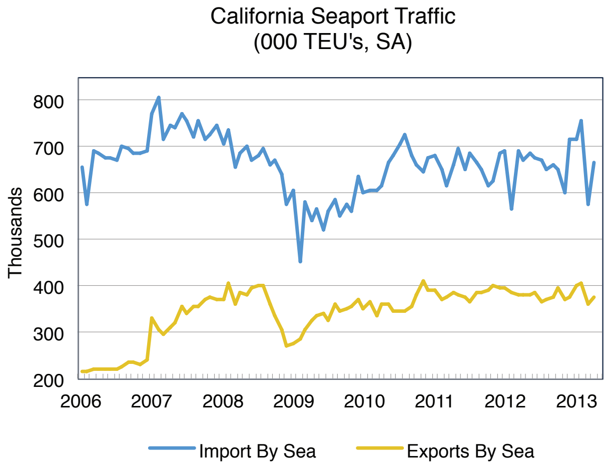


Figure 9.
California Seaport Trafic



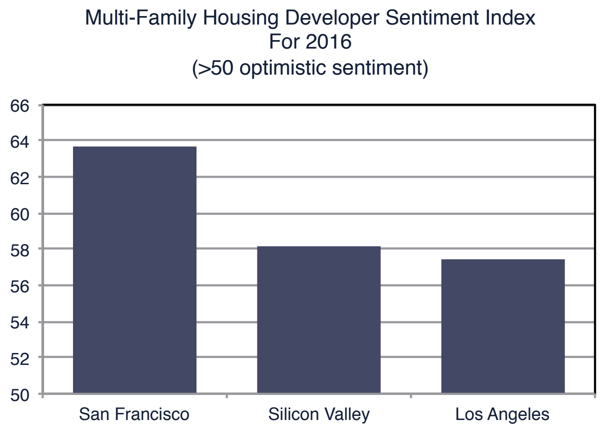
CALIFORNIA MULTI-FAMILY HOUSING SPACE MARKETS

The current survey marks the third Allen Matkins / UCLA Anderson Forecast survey of multi-family housing developers. In each of the three markets surveyed, Los Angeles, San Francisco, and Silicon Valley, the panel continued to be optimistic about the prospects for returns on multi-family housing in the coming three years. The survey indicates that the market outlook is sufficiently bright for 55% of our panel or their associates to begin new multi-family projects in the coming 12 months.

The booming San Francisco market, for example, has seen rents increase at double-digit rates and vacancies fall to approximately 3%. This has given rise to a number of new building projects including the massive Park Merced, Treasure Island, Mission Rock, Pier 70 and Hunter's Point developments as well as a flurry of new apartment building in The Mid-Market District.

In Downtown Los Angeles, apartment vacancy rates have fallen to about 2% spurring a host of new apartment projects including the oft-postponed Grand Avenue mixed use development. The favorable fundamentals, reflected in our Multi-Family Developer Sentiment Index, and a Los Angeles City plan to facilitate permitting of multi-family projects near the newly opened light rail lines marks the beginning of a building boom in the County. As job formation continues in the coming years, so will household formation and the demand for multi-family housing is expected to remain strong. As with Office and Industrial Space Markets, the components of the Sentiment Index for Multi-Family Housing now indicate a movement towards a balance between new additions to multi-family housing and the absorption of those additions by 2016.

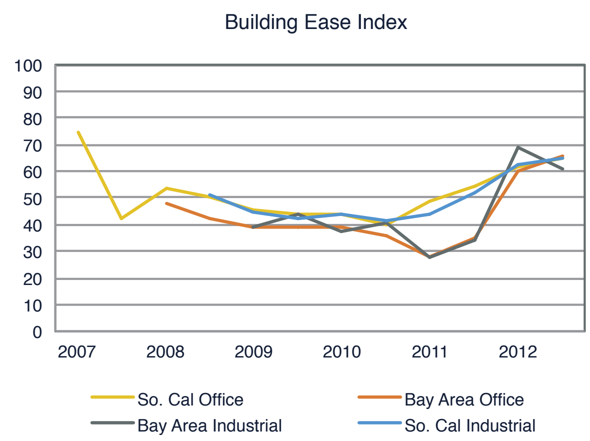
Figure 10.
Multi-Family Housing Developer Sentiment Index



BUILDING COST AND FINANCING INDEXES

The Survey Project also generates a building cost and financing index. This metric measures the expected improvement or deterioration in the cost of building and is a companion to market sentiment. The index measures changes to the physical and financial costs of building over the coming three years as opposed to the Sentiment Index that measures developer views three years into the future.

Figure 11.
Building Ease Index



In all four of our markets the BCF Index declined from 2009 to 2011. This reflected a perception on the part of developers that land costs will be increasing faster than the rate of inflation over the subsequent three years and financing would be at least as difficult as today. In the second half of 2011 the BCF Index increased for all of the markets and it continues to improve with the current survey. This is primarily due to a perception of an improvement in the availability of funds and the terms and conditions for obtaining funds for new development projects. While our experience with the BCF Index is not as deep as with the Developer Sentiment Index, the two indicate a return to normal non-residential construction in the coming years.

SUMMARY

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 2016 in the Survey 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. Importantly, the Indexes are now giving insight into the topping out of the market in the three to four year time horizon. They clearly do not predict a downturn, but they do predict markets where both demand and supply are growing at a more measured rate.

1. http://www.edd.ca.gov.

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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.

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