

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](http://www.uclaforecast.com).



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

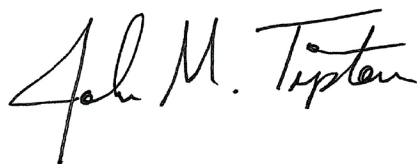
Allen Matkins and UCLA Anderson Forecast have partnered to create a Commercial Real Estate Survey and Index to better predict future California commercial rental and vacancy rates. This tool surveys supply-side participants – commercial developers and financiers of commercial development – for insights 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 ninth 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: Catching Up With Fundamentals

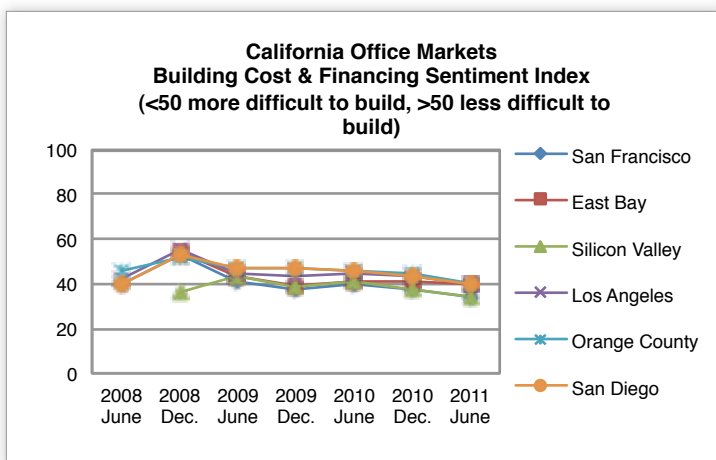
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In his article on U.S. commercial real estate, UCLA Anderson Forecast Senior Economist David Shulman makes the case for asset prices being out in front of fundamentals. Over the last eighteen months Class A asset prices in the commercial sphere climbed back to 90% of their previous peak, while rental and occupancy rates have remained at their recession lows.<sup>1</sup> The easy money policy of the Fed, combined with a below normal equilibrium number of properties available, has led to a rapid price recovery. Yet in most markets, California included, commercial real estate has shown virtually no sign of improvement. This disconnect between asset prices

and the earning potential of those assets is a suggestion of either a bubble, or a coming recovery in fundamentals. The June Allen Matkins / UCLA Anderson Forecast Commercial Real Estate Survey of a panel of developers suggests the latter. The survey results, presented below, show developer sentiment in all regions of California as being optimistic, and in some cases increasingly so, with regard to commercial markets in 2013 and 2014.

How do we reconcile this disconnect between asset prices, fundamentals and the survey panels' 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 the two year period following the onset of a recession. After the recession shakeout, 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.<sup>2</sup> 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 will occur even when markets look as they do today.



Secondly, the run-up in asset prices is in part due to an excess of liquidity. A similar run-up occurred in the two years following the 2001 recession. Nationally, the 2001 recession exhibited a much less pronounced price cycle with close to a 25% swing rather than the current 60%. Typically, an excess of liquidity will lead investors to search the market for those transactions that have the most potential. So the rapid recovery in Class A property values, while not reflecting current fundamentals, does say something about investor expectations of future fundamentals relative to other potential investments. The Allen Matkins / UCLA Anderson Forecast Survey and Index began in 2007. Therefore, we can only speculate as to what it might have shown in 2003 and 2004. Nevertheless, the Survey results do comport with the current movement in asset values.<sup>3</sup>

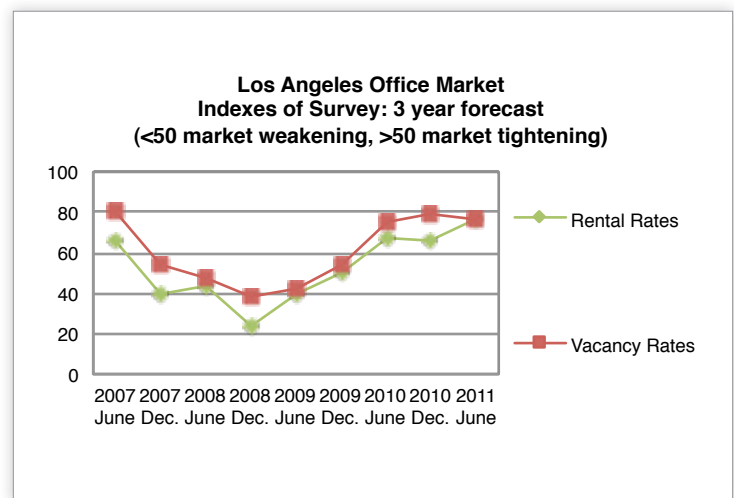
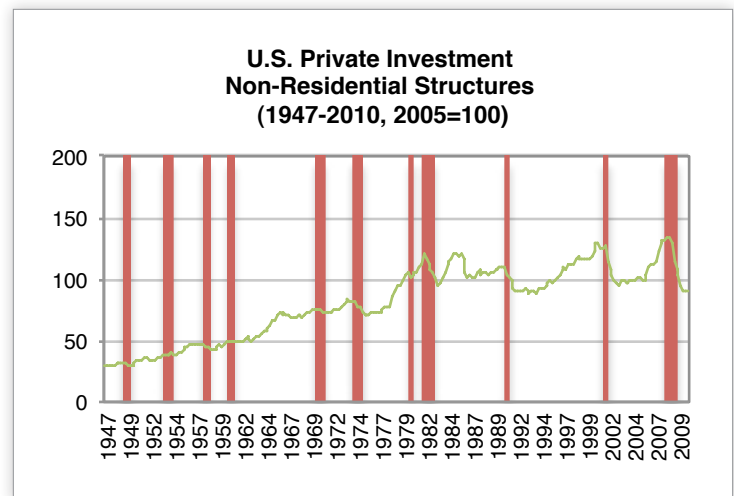
The Allen Matkins / UCLA Anderson Forecast Survey and Index Project compiles the views of commercial real estate developers with respect to markets three years hence. Their sentiment is a good indicator of current developer expectations and future market activity as three years is the average decision window for the bulk of large commercial projects. The current release introduces a new index from the survey, the Building Cost & Financing Sentiment Index. This index is designed to capture the changes in the expected ease or difficulty of bringing new office space into the market.

### Southern California Office Markets

In Southern California, owners of office space in some sub markets are finally beginning to see some tangible evidence of an incipient recovery. Clearly Southern California office space markets have not recovered and fundamentals do not by themselves support today's property prices, but they are getting better.<sup>4</sup> However vacancy rates remain quite high through the region and improvement in some markets is at the expense of others.<sup>5</sup>

The confusing market signals come from the nature of office demand. It is highly localized and thus, the timing of a turn in a particular market is not necessarily synchronized with other nearby markets.<sup>6</sup> What we are observing today in Southern California office markets is the churn that exists before the overall market begins to turn. From the perspective of our

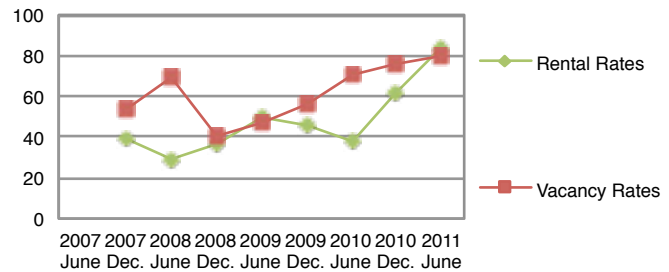
panel of experts, who in spite of the underwhelming employment numbers<sup>7</sup> are seeing the recovery take hold, current and scheduled new supply is insufficient to hold down rental and occupancy rates into 2013 and 2014.



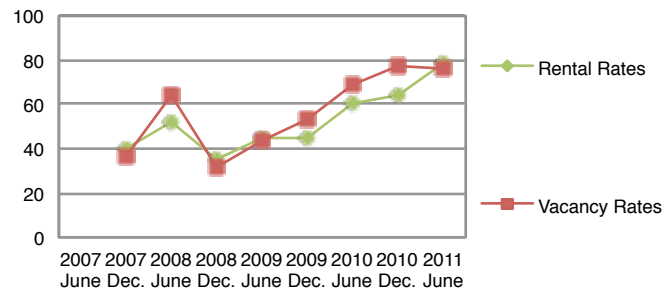
**The June 2011 Survey of Developer Sentiment for Southern California Office Markets highlights are:**

1. In Los Angeles and San Diego, the high vacancy rates are due more to the economic downturn than to overbuilding.
2. The Los Angeles and San Diego panel sentiments increased over the last six months.
3. This increase in sentiment is likely due to both spill-over effects of the ebullient asset markets, and an expectation of a more robust recovery in demand by 2013 than has been seen thus far.
4. The Anderson Forecast for office using employment is consistent with the timing indicated by the Survey.
5. In Orange County, the collapse of the sub-prime mortgage finance sector resulted in a de facto overbuilt market. The high vacancy rates are both a function of demand and supply.
6. The Orange County panel shifted from pessimism to optimism in December and remained optimistic in June.
7. The structural imbalance in Orange County suggests the panel's optimism may not reflect sufficient confidence to engender significant new building over the Survey's horizon.

**Orange County Office Market  
Indexes of Survey: 3 year forecast  
(<50 market weakening, >50 market tightening)**



**San Diego Office Market  
Indexes of Survey: 3 year forecast  
(<50 market weakening, >50 market tightening)**



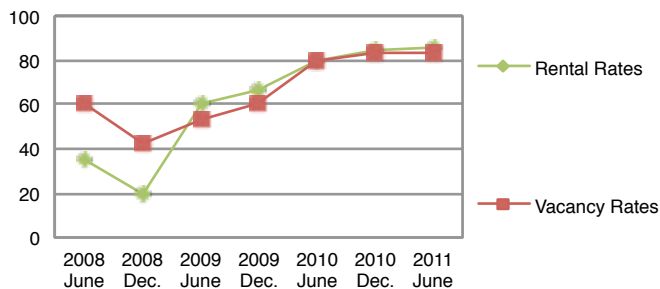
## Bay Area Office Markets

At the peak of the office market the Bay Area experienced a boomlette in new office space construction resulting in a significant excess supply of space by late 2009.<sup>8</sup> As the economy imploded, construction fell back to the near zero levels experienced earlier in the decade.<sup>9</sup> However, the boomlette left some sub-markets, particularly in Silicon Valley, with an oversupply of office space. The Bay Area leads California in the recovery with growth in technology, exports and advanced manufacturing. This increased activity had led to significant new leases by tech companies and new building projects in San Francisco and the Peninsula<sup>10</sup> being put together. Thus, it is not surprising that our Bay Area Office Market Developer Sentiment Survey has moved from developer optimism to developer enthusiasm.

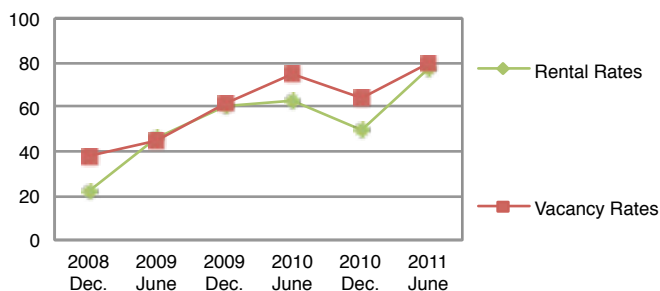
### The June 2011 Survey of Developer Sentiment for The Bay Area Office Markets highlights are:

1. In San Francisco, the high vacancy rates are due to the economic downturn and contraction in government employment
2. The panel's view of the difficulty of building in San Francisco has turned more pessimistic
3. The panel is increasingly optimistic with regard to rents and vacancy rates in San Francisco reflecting both asset price appreciation and expectations of continued growth in office using demand.
4. Silicon Valley office space was overbuilt and high vacancy rates are due to both supply and demand conditions.
5. The demand for equipment and software has increased office space demand over the past 18 months.
6. The panel is increasingly optimistic about rents and occupancy in Silicon Valley looking forward to 2013 and 2014.
7. The East Bay contraction in demand in the 2008 recession included a reduction in occupancy by the finance and government sectors. This represents a structural shift in demand in the East Bay.
8. The East Bay panel remains optimistic, but not increasingly so, with respect to 2013 and 2014.

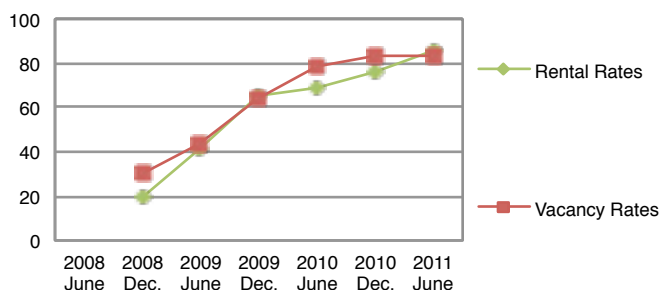
**San Francisco Office Market  
Indexes of Survey: 3 year forecast  
(<50 market weakening, >50 market tightening)**



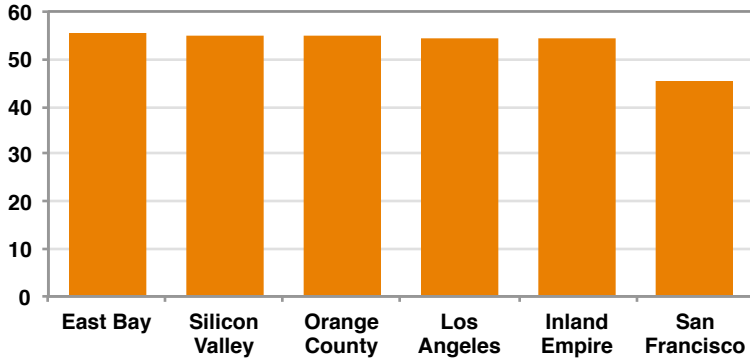
**East Bay Office Market  
Indexes of Survey: 3 year forecast  
(<50 market weakening, >50 market tightening)**



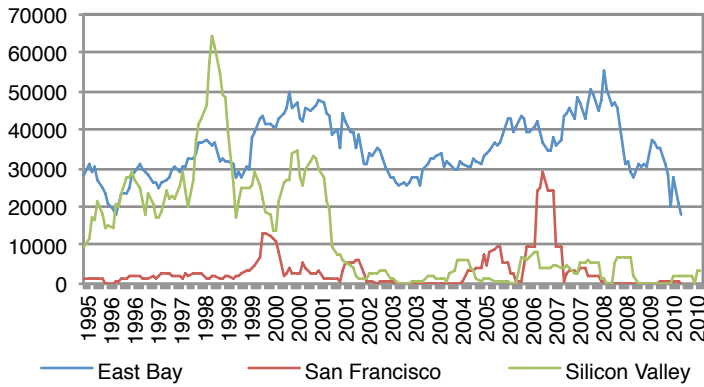
**Silicon Valley Office Market  
Indexes of Survey: 3 year forecast  
(<50 market weakening, >50 market tightening)**



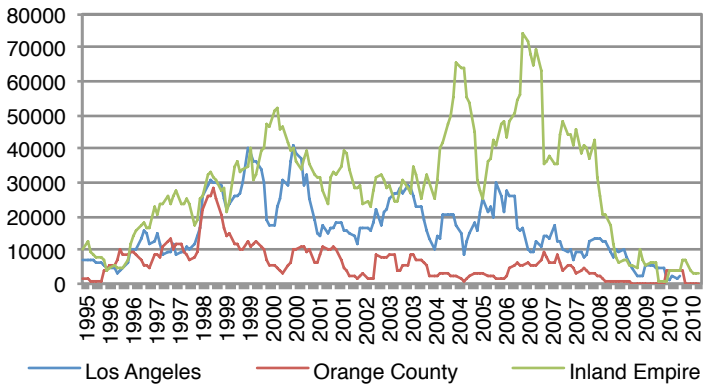
**INDUSTRIAL DEVELOPER SENTIMENT SURVEY**



**Permits for new industrial building (\$000, six month moving average)**



**Permits for new industrial building (\$000, six month moving average)**





## 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 best characterized as being driven by recent growth in 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 a growth in California manufacturing, and slow-to-no-growth in consumer goods imports through the California's ports.

The Allen Matkins / UCLA Anderson Forecast Industrial Space Survey and Index Project is now beginning its second year. While the Survey provides insight into the thinking of industrial space developers, the history of the Survey is still quite small and not admitting of trend analysis. Spatially, the survey shows some interesting results.

1. The Bay Area panel is most optimistic about the East Bay as it captures technology manufacturing from other parts of the Bay Area and warehousing for the burgeoning exports through the Port of Oakland.
2. The panels are only slightly less optimistic about 2014 with regard to Silicon Valley and Orange County, centers of technology manufacturing.
3. The Southern California panel is slightly less optimistic about 2014 for Los Angeles and the Inland Empire. Los Angeles is the largest manufacturing center in the U.S., but is also home to the largest port complex in the U.S. and both Los Angeles and the Inland Empire have large import logistics sectors.
4. The panel for San Francisco is the least optimistic due to space and financing limitations.

## 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 2014 in the Survey, which first appeared last June 2010, 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 we have now seen one year of optimism. While continued, and in some cases increased, optimism may be spillover from a run up in asset prices and not reflective of underlying economic conditions, it is also consistent with the historical pattern of commercial real estate cycles. The depth of the recession and the recent slowing of growth will perforce attenuate a recovery in commercial real estate markets. However, the continued optimism is still suggesting a turning point in commercial markets and commercial construction by 2013.

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1. "Asset Prices In Front of Fundamentals," David Shulman, UCLA Anderson Forecast, June 2011.
  2. Data source: <http://www.bea.gov>
  3. The first sign of the recovery was reported in "Images of A Recovery," Allen Matkins UCLA Anderson Forecast December Survey Results, January 2011.
  4. See for example: Roger Vincent, "Office Lease Markets Show Signs of Recovery," Los Angeles Times, April 17, 2011. And Voit Real Estate Services [http://www.voitco.com/ftp/SC\\_1Q11\\_Market\\_Update\\_SR.pdf](http://www.voitco.com/ftp/SC_1Q11_Market_Update_SR.pdf)
  5. See Jacquelyn Ryan, "Glendale's Boons Become Busts as Business Departs," Los Angeles Business Journal, June 27, 2011. For a discussion of how downtown markets are attracting insurance companies previously located in Glendale.
  6. Alex Finkelstein, "Santa Monica Office Market Rebounds While The Rest of California Stumbles," The World Property Channel, April 2011. Matt Bechard, "Improvement in The Southern California Office Market," REIT.com, December 8, 2010.
  7. Source: EDD; office using employment is approximated by Information, Financial Services, Professional and Business Services, Education, Health Care and Social Services and Government sectors. The percentage was calculated using May 2010 employment figures.
  8. Dan Levy, "Silicon Valley 'bloodbath' leaves buildings empty (Update 2)," <http://bloomberg.com> January 5, 2010.
  9. See for example: <http://www.aegisrealty.com>
  10. CB Richard Ellis, "San Francisco Bay Area Office Regional Summary," 2011. <http://bayareacomre.com/2010/12/21/silicon-valley-heads-north-the-office-boom-in-sfs-soma-district/>

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**FORECAST**

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

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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