

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

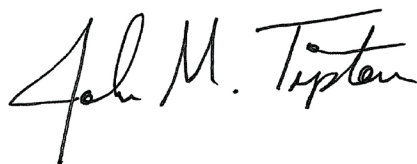
Allen Matkins and UCLA Anderson Forecast have partnered to create a Commercial Real Estate Survey and Index to better predict future California commercial rental and vacancy rates. This tool surveys supply-side participants – commercial developers and financiers of commercial development – for insights 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 tenth 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 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 Office and Industrial Markets: A Recovery Begins

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Senior Economist

The title of this semi-annual release of the Allen Matkins UCLA Anderson Forecast CRE Survey may seem odd given the mixed economic signals of the past six months. In the time since the last Survey release, the U.S. economy slipped into a near stall with sub-2% GDP growth, talk about a double dip recession was rife, and market confidence was shaken by gridlock in Washington and the saga of European sovereign debt. During these same months, employment and retail sales figures, while not robust, have continued to indicate an ongoing general economic recovery. Consistent with the national economic news, California's office and industrial space markets have made some, albeit uneven, progress.

The progress, such as it is, has been driven by the steady employment gains in coastal California, particularly in professional, technical and scientific services and health care, users of office space, and in export related sectors and manufacturing, users of industrial space. The Allen Matkins / UCLA Anderson Forecast Survey of Commercial Real Estate foretold the turn in commercial real estate in California in the June and December 2010 and July 2011 Surveys. The latest survey results, December 2011, exhibit a continuation of the last 24 months, and for the first time, the Survey provides evidence of a nascent new build cycle.

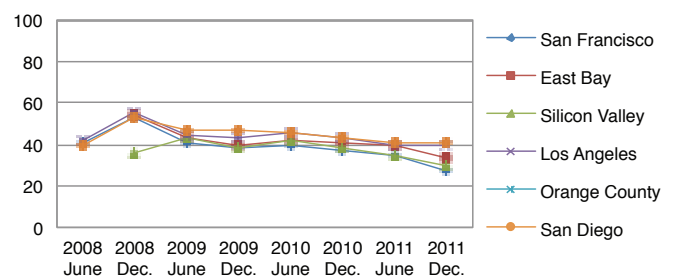
Although occupancy rates and rental rates have not yet risen to levels required to induce significant new construction, improving economics has induced an increase in alterations and remodeling of existing space. In the last six months, permits for remodeling of commercial real estate in the seven surveyed markets (exclusive of apartments) reached or exceeded the pre-2007 levels. While the dollar value of the remodeling does not account for inflation and may be allocated to very different types and uses of commercial real estate, they do indicate a move towards conditions appropriate to engender a revitalization of the commercial structure construction industry<sup>1</sup>.

The Survey project also generates a building cost and financing index. The index has deteriorated of late in the

Bay Area, particularly Silicon Valley, due to a perception on the part of developers that land costs will be increasing faster than the rate of inflation over the next three years. Nevertheless, in the Bay Area one third of the panel reported that either they or their associates were beginning the process of putting together one or more new office building projects. In Southern California there was less of a concern about rising land costs, however, the proportion of the Southern California panel or their associates beginning new projects was lower than in the Bay Area at about 15%.

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 be approximately 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.

**California Office Markets  
Building Cost & Financing Sentiment Index  
(<50 more difficult to build, >50 less difficult to build)**



## Southern California Office Markets

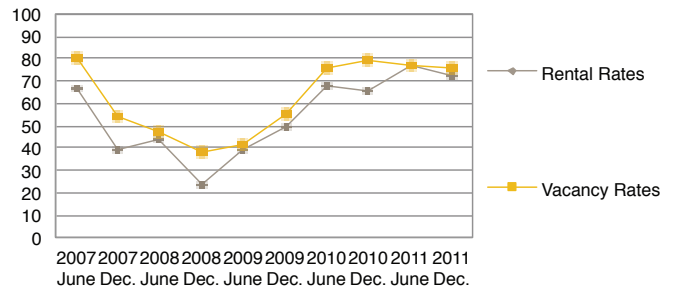
In Southern California, owners of office space in some submarkets are finally beginning to see tangible evidence of a recovery taking hold<sup>2</sup>. Clearly Southern California office space markets have not recovered and fundamentals do not by themselves support another building spree, but the free-fall of 2008 and 2009 is over and office markets are, little by little, getting better<sup>3</sup>. In line with improved rental and occupancy rates in Southern California sub-markets is the beginning of some new office construction. From lows at or near zero in 2009, permits have risen to about 1/6th their peak and are now at the somewhat depressed levels of 2002 and 2003.

Although the Allen Matkins UCLA Anderson Forecast CRE Survey covers regional markets, it is important to note that sub-markets may differ widely in their demand and supply characteristics. Moreover, the timing of a turn in each market is not necessarily synchronized with other nearby markets<sup>4</sup>. From the perspective of our panel of experts, who are observing gradually improving regional employment numbers<sup>5</sup>, current and scheduled new supply is insufficient in general to hold down rental and occupancy rates into 2013 and 2014.

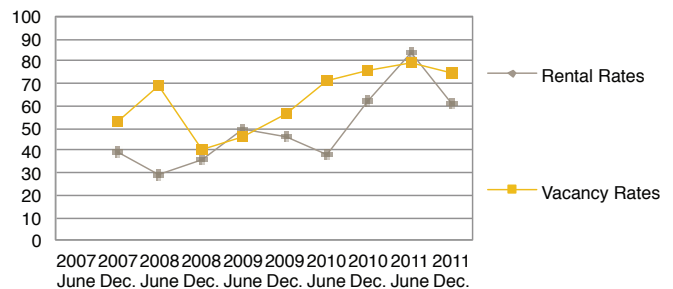
The December 2011 Survey of Developer Sentiment for Southern California Office Markets highlights are:

1. The Los Angeles and San Diego Sentiment Index with respect to vacancy rates dropped, but by an insignificant amount and remained highly optimistic.
2. This drop is likely due to an extrapolation of the slower job growth experienced in the last six months. The December 2011 Anderson Forecast for office using employment is consistent with the timing indicated by the Survey.
3. The Orange County panel remained optimistic with respect to 2014, but a bit less so than in the other two Southern California markets.
4. Developer optimism combined with stronger job growth in San Diego and coastal Los Angeles County suggest non-residential construction will return to San Diego and parts of Los Angeles before the balance of Los Angeles County and Orange County.

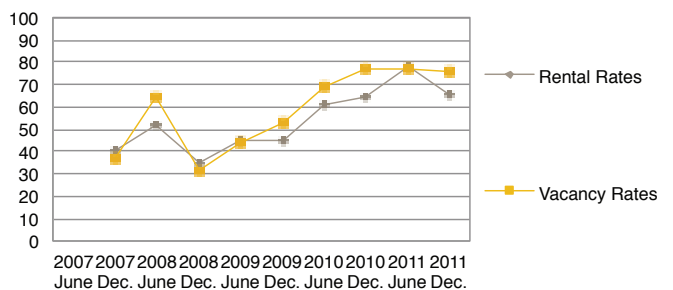
**Los Angeles Office Market**  
Indexes of Survey: 3 year forecast  
(<50 market weakening, >50 market tightening)



**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

Since the beginning of the recovery, the Bay Area has grown faster than the U.S. and has added jobs in office using sectors and in manufacturing. For 2010, the San Jose MSA's output grew at a blistering 12%.<sup>6</sup> Employment growth, particularly in San Francisco and Silicon Valley, has outpaced the U.S. and leads the recovery in California.<sup>7</sup> With information technology, computers, electronics and software driving Silicon Valley employment and social media and software development driving San Francisco employment, occupancy rates in these markets are rising and rental rates are firming. At the same time, the East Bay market is still recovering from the loss of demand for office space from a consolidation of the finance industry and the lackluster consumer products logistics industry. Nevertheless, the region as a whole is growing, and since the ongoing U.S. recovery will most likely continue to be led by technology based products, Bay Area office markets ought to continue to improve.

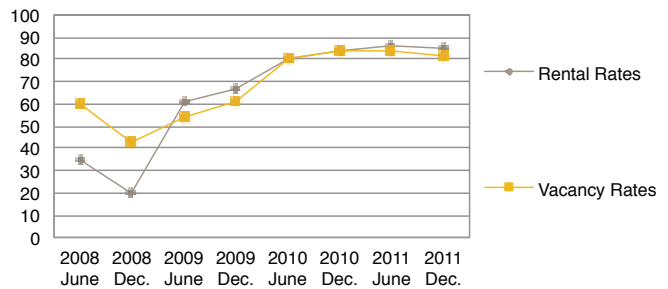
Against this backdrop is a lack of permits for new building. Only in San Jose is there evidence of new building, though this activity is only at about one third of its previous peak. The refurbishment of older buildings has steadily increased over the past year to near peak levels in both Silicon Valley and San Francisco. All of these facts suggest that significant new building is in the not too distant future and there is some anecdotal evidence to support that view.<sup>8</sup>

Our panel of developers remains bullish on the Bay Area. Although there are few new permits at the end of 2011, an action that tends to take place towards the end of the planning process, one third of our panel reports that they or their associates are at the early stages of at least one new building project. Thus, the optimism that has been manifest in the Allen Matkins UCLA Anderson Developer Sentiment Indexes for the last two years in Bay Area Markets is beginning to translate into new office space development.

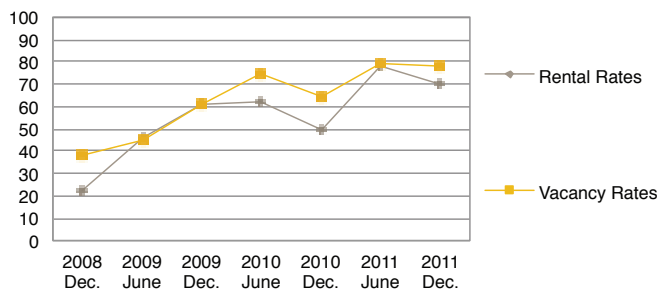
The December 2011 Survey of Developer Sentiment for The Bay Area Office Markets highlights are:

1. In San Francisco developer sentiment was unaffected by the slowing of economic growth in the last two quarters of 2011.
2. In the East Bay, sentiment remained optimistic though slightly less so with respect to rental rates.
3. In Silicon Valley, sentiment remained optimistic though slightly less so with respect to vacancy rates.
4. The Bay Area optimism is borne out by both current trends in employment and the Anderson Forecast Bay Area economic model.
5. The Survey and existing fundamentals suggest that San Francisco and Silicon Valley non-residential construction ought to be the first California market to exhibit renewed growth in this cycle.

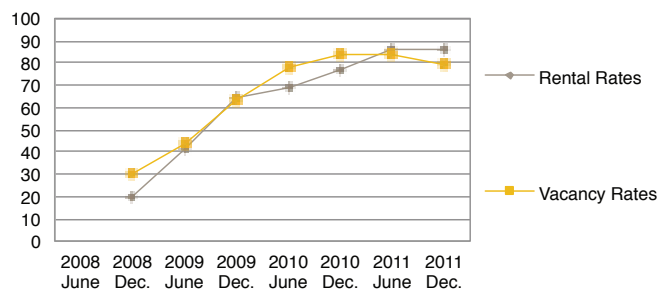
**San Francisco Office Market**  
Indexes of Survey: 3 year forecast  
(<50 market weakening, >50 market tightening)



**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)



## California Industrial Space Markets

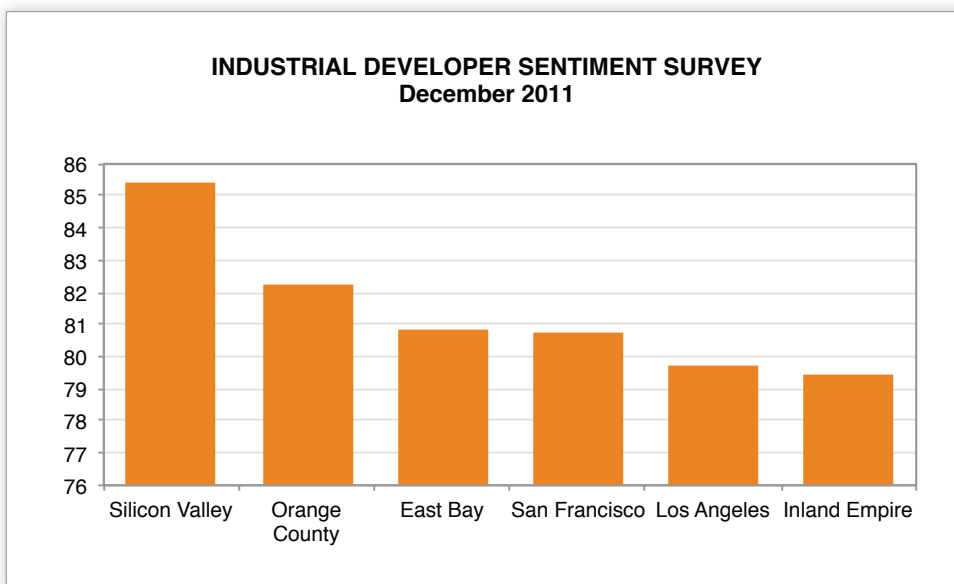
Industrial Space is comprised of two distinct markets, manufacturing and warehousing. Although each geography is a mixture of both, San Francisco, Silicon Valley and Orange County can be broadly characterized as being more heavily manufacturing, the East Bay, and Los Angeles a mix of the two, and the Inland Empire by warehousing. The basic underlying economic forces in industrial markets are a growth in California manufacturing, a growth in exports and slow-to-no-growth in consumer goods imports through the California's ports.

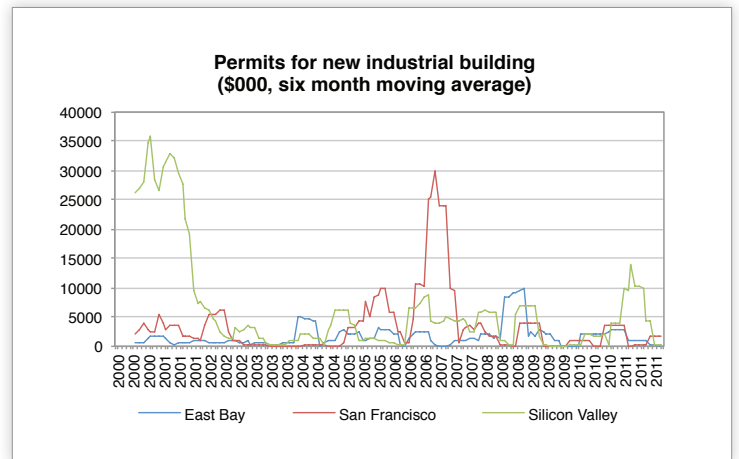
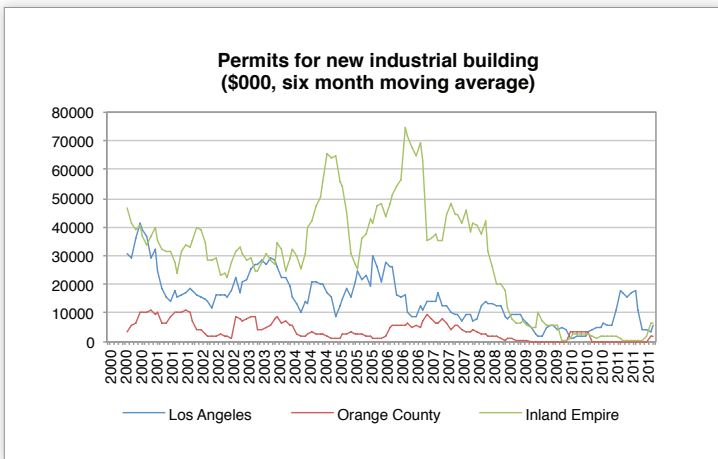
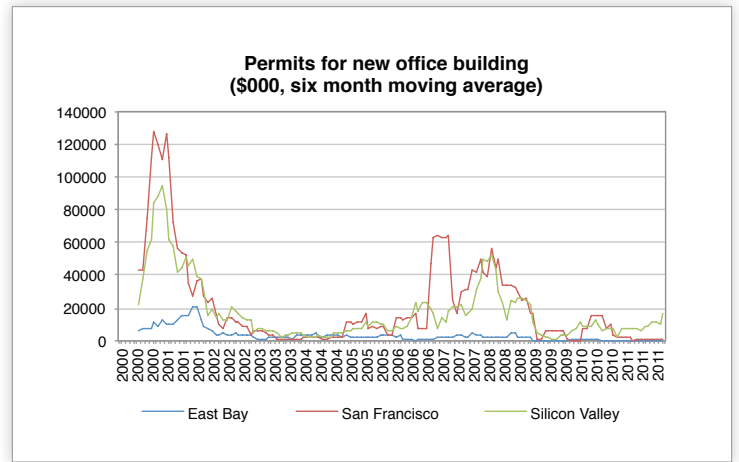
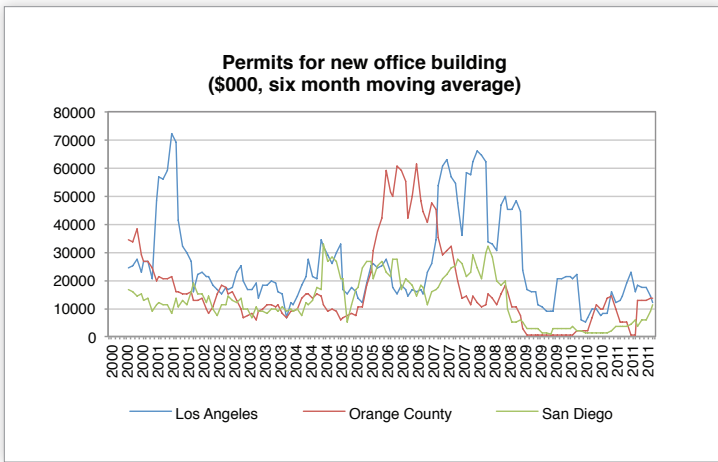
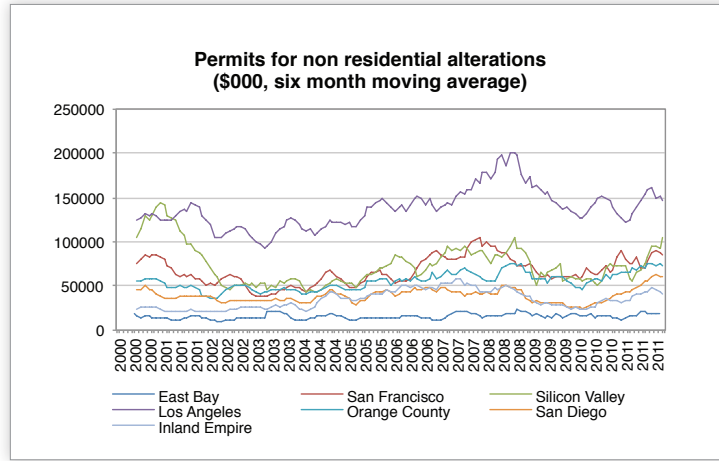
Six months ago developers were most optimistic about the East Bay. That has changed somewhat with the slowing of export growth through the Port of Oakland. An easing of economic growth in Asia and the slide into recession in Europe has dampened, though not qualitatively changed, developer optimism with respect to industrial space in the East Bay. Overall, the Bay Area and Southern California panels maintain an optimistic view

for California industrial markets to 2014. This optimism has now translated into activity on the initial stage of new building projects.

Highlights of the December 2011 Industrial Space Survey are:

1. The Bay Area Panel is most optimistic with regard to Silicon Valley and least with respect to San Francisco.
2. About 1/3 of the Bay Area panel or their associates are planning new projects as of December.
3. Of the Southern California markets, the panel's sentiment reflects the greatest optimism with respect to Orange County.
4. Los Angeles and the Inland Empire still score in the "market tightening" range for the Industrial Space Index, but are less robust than the other markets.
5. Three quarters of the Southern California Panel reports they or their associates are in the process of putting together new industrial space projects.







## Summary

The Allen Matkins / UCLA Anderson Forecast survey was designed to improve forecasting of 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 in some markets in December 2009, 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. The eighteen months of pessimism during the recession has now been followed by two years of increasing optimism among the Survey panels. This is qualitatively consistent with the historical pattern of commercial real estate cycles. The depth of the recession and the recent slowing of growth have attenuated the recovery in commercial real estate markets, however, the Survey results are still suggesting a turning point in commercial markets and commercial construction by late 2012. ■

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1. The first sign of the recovery was reported in "Images of A Recovery," Allen Matkins UCLA Anderson Forecast December Survey Results, January 2011.
  2. See for example: Roger Vincent, "Southland Office Rents, Occupancy Rates Stay Low," Los Angeles Times, October 16, 2011 and Roger Showley, "Office market Improving at 'lethargic' pace," San Diego Union Tribune, October 20, 2011.
  3. Dennis Macheski Consulting reports a peak in vacancies in late 2010 and a bottom in rental rates in early 2011. With little to no building and absorption becoming positive with recent job gains, they expect this turn in the market to hold.
  4. Also see "Office Market Report: Los Angeles Q3 2011," Charles Dunn.
  5. Alex Finkelstein, "Santa Monica Office Market Rebounds While The Rest of California Stumbles," The World Property Channel, April 2011.
  6. And Jones, Lang and LaSalle, Local Office Statistics.
  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. <http://www.bea.gov>
  9. <http://www.edd.ca.gov>
  10. See for example: Mark Mueller, "Irvine Company Plans Office Campus in Silicon Valley," Orange County Business Journal, November 6, 2011.

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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

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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