

# Southern California

# Market Perspective



Fall 2005

Los Angeles

Orange

Riverside

San Bernardino

Ventura

Southern Kern Counties

**NAI Capital**  
Commercial Real Estate Services, Worldwide.

Dear Reader,

We are pleased to present to you our Fall Market Perspective Report.

The first article in this report presents the findings from our Fourth Annual Survey of NAI Capital brokers. This survey indicates that 2006 should be yet another good year for landlords in the Los Angeles Basin, and a difficult year for tenants (particularly those looking for space in retail or industrial buildings). Market conditions are projected to remain very tight for the retail and industrial markets, moderately tight for the apartment market, and tightening for the office market. Our brokers say that current interest in future requirements is strong for all four product-types, driven by a strong local economy and by a shared perception among firms throughout the basin that now is the time to expand. Importantly, demand is growing once again from the entertainment and high-tech sectors. Demand to buy is also strong, driven by still-low interest rates and perceived lack of opportunities in alternative investments.

Construction activity is projected to remain restrained, particularly in urban areas, due to a lack of vacant land. As vacancy rates drop (or stay at current low levels), rental rates are projected to climb significantly, particularly for office and apartments. Sale prices are also projected to continue to climb significantly, although at a slower pace than the superheated level of the past two years.

Record-high prices and record-low cap rates, however, have increased the risk of a price correction. A number of brokers expressed concern that a correction could take place if interest rates should suddenly and/or significantly climb.

The second article in this report presents the latest data on sale prices and cap rates by property type. This data shows that average sale prices are up 17% in the past 12 months for retail, 15% for industrial, 11% for office and 9% for apartments - strong growth, particularly considering the large price increases that took place in 2003 and 2004 in most property types. Average cap rates have fallen into the 5% range for apartments and into the 6% range for retail, industrial and office - exceptionally low rates.

As always, we hope that the information contained in this report is useful to you. More detailed data can be obtained from our brokers on specific markets and property types. We look forward to working with you to interpret the implications of these trends upon your own real estate needs.

Sincerely



Michael Zugsmith  
Chairman



Robert Scullin  
Chief Executive Officer



Rachel Howitt  
Chief Financial Officer

## FOURTH ANNUAL NAI CAPITAL BROKER SURVEY

The office market in the Los Angeles Basin is rapidly tightening and rents are starting to spike in some areas. The industrial, retail and apartment markets have been tight for the past two to three years and have reached hyper-tight status in some markets. Both local and national investors have placed Los Angeles Basin real estate on their target lists, and users are leveraging very low interest rates to buy properties that meet their needs. Sale prices have hit record highs and cap rates record lows. Some are worried that this has been "too much of a good thing for too long" and that a correction is imminent. Others point to the fact that construction is still greatly lagging growth in demand in most areas, and that opportunities will continue to exist unless we start to over-build again.

In order to provide insight to this and other real estate issues, we have once again conducted a survey of NAI Capital brokers about what they are seeing in the marketplace. As pointed out in previous survey reports, the brokers at NAI Capital are among the first to spot a trend in the marketplace. They have day-to-day exposure to a wide variety of players including tenants from different industries, landlords, developers, investors and financiers. They are part of the decision-making process, and the decisions that their clients are making today won't show up in the market statistics for another three to six months.

We first formally tapped into this resource in a survey of NAI Capital brokers in the Fall 2002, and repeated the survey in the Falls of 2003 and 2004. Those surveys accurately predicted a number of trends that have since taken place, including the tightening that has taken place in all property types and the strong growth in demand among investors and owner-users.

*Market conditions projected to tighten in all property segments in 2006*

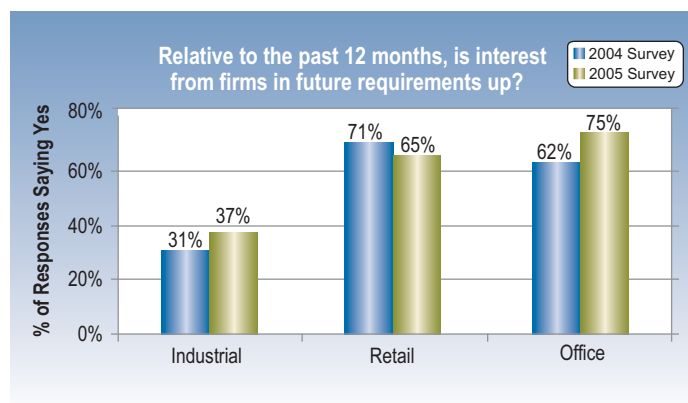
In the Fall of 2005, we repeated that survey, and present our findings to you in this report. The major findings from this survey include:

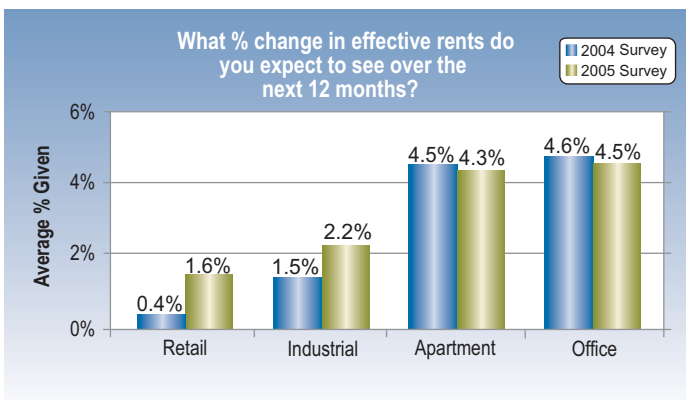
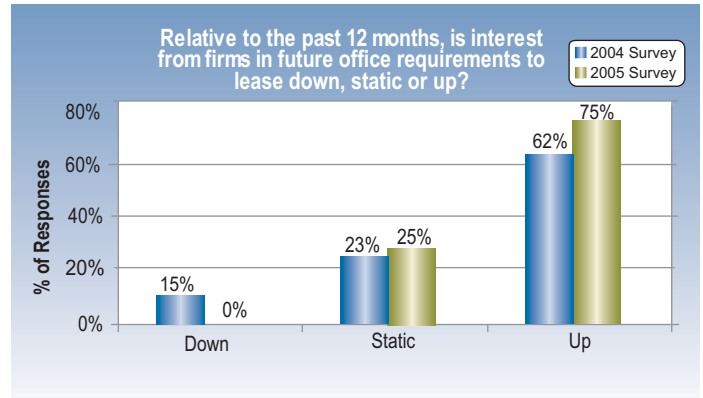
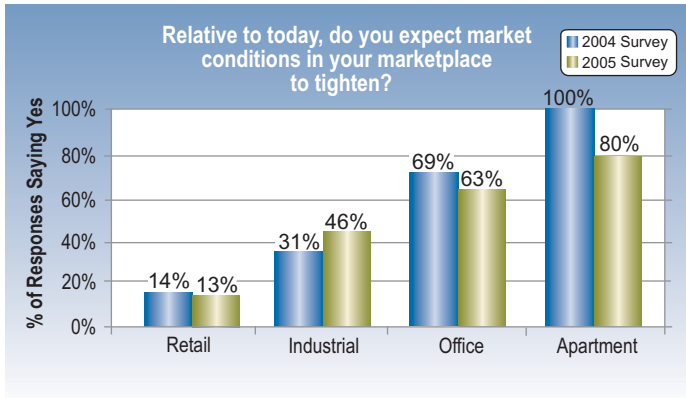
- Interest in future office requirements continues to accelerate and construction activity, while up, remains below projected demand. Vacancy rates are projected to

continue to drop, and strong effective rent growth is projected (+4.5%).

- Interest rates did not climb significantly in 2005 as expected; as a result, for-sale industrial product continued to capture market share from for-lease product. This situation is expected to reverse itself in 2006, and leasing activity is expected to increase significantly. Market conditions are expected to remain tight or to tighten even further, keeping rental rates and sale prices firm.
- The retail market is projected to remain tight into the foreseeable future. Rental rates and sale prices are projected to climb from their current high levels at a moderate pace.
- The apartment market is projected to tighten even further, with vacancy rates in urban areas falling to the low 3% range. Rents and prices are projected to continue to climb at a strong pace (+4.3% and 5.5% respectively). The greatest opportunities continue to be seen in Class B and C properties.

Note, however, that a growing number of respondents expressed concerns about the heights to which sale prices have climbed and cap rates have fallen. The greatest concern expressed was whether prices might take a hit if interest rates were to suddenly and/or significantly climb.

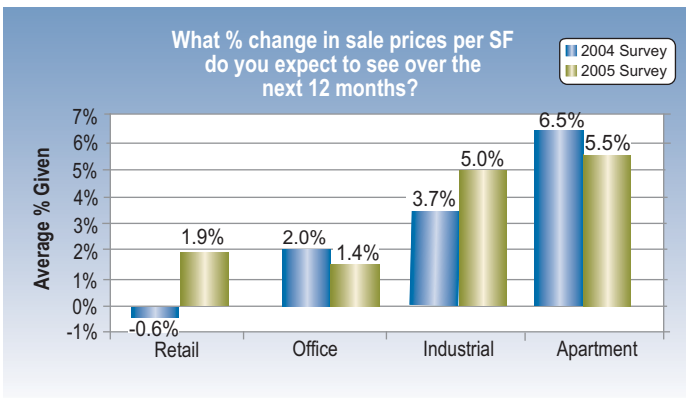




months ago (62%), 24 months (50%), and 36 months ago (just 8%). Clearly, interest is accelerating.

The increase in interest is broad-based, including from firms in professional services, finance (particularly mortgage-related), entertainment, and for the first time since 2000, technology (including dot.com firms, as well as communications).

*Interest up from dot.com firms once again*



Nearly half (48%) of the brokers surveyed expect that leasing activity over the next 12 months will pick up (from a level that is already high), and slightly more than half (52%) expect it will maintain its current healthy pace. None expect a slowing.

Construction is currently restrained. Only 3.3 million SF is underway, which, when complete, will expand the existing base by just 1%. Most of those surveyed expect construction activity to remain restrained for another 12 months. However, in some markets (including South Orange County), an up-tick is expected.

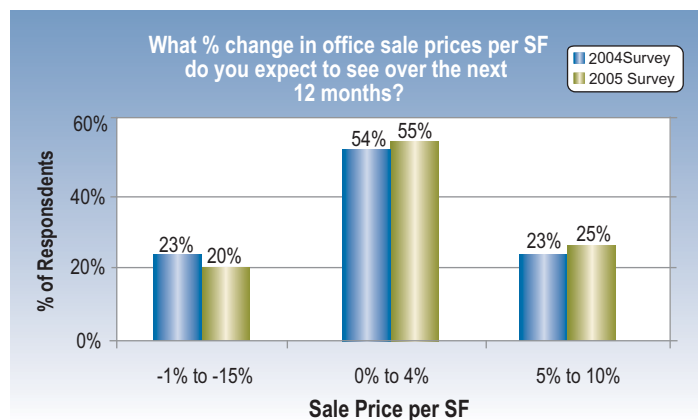
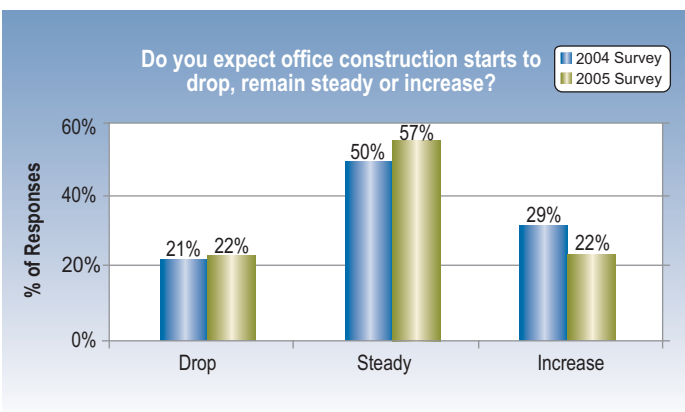
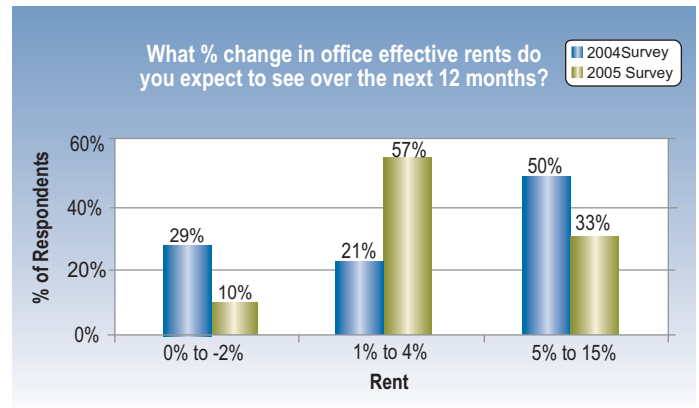
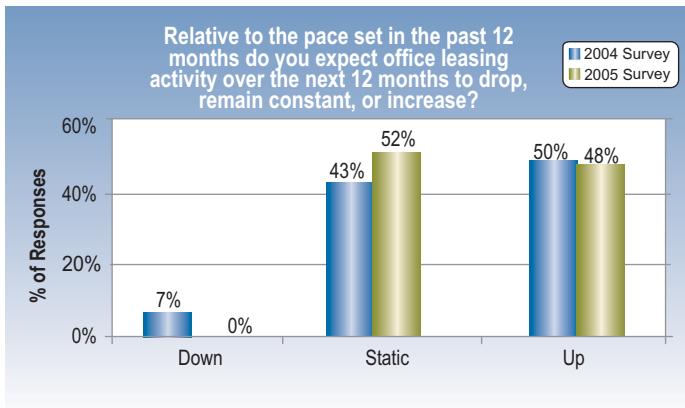


## DETAILED FINDINGS

### Office

As predicted in the survey held last year, the Los Angeles Basin office market has tightened significantly in the past 12 months. Vacancy rates are down three percentage points (to 11%) and rental rates are up 6%. Importantly, according to our survey, this trend is expected to continue into 2006.

75% of the office brokers surveyed said that interest in future requirements is up. This is substantially higher than 12



As a result of the projected increase in demand and restrained construction, nearly two-thirds (63%) of those surveyed anticipate a continued tightening in office market conditions over the next 12 months. Few expect a softening. This is consistent with the outlook 12 months ago, when the majority also projected a tightening (as indeed, turned out to be the case).

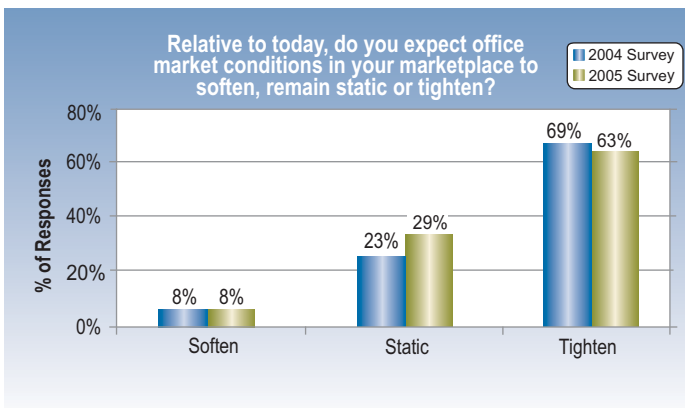
*Nearly 2/3rds expect the market to tighten*

57% of those surveyed expect effective rental rates to climb by a moderate 1% to 4%, and a third expect more robust growth of 5% to 15%. This is down from 12 months ago, when half expected strong rent growth. Effective rents are projected to climb by 4.5%, on average.

Sale prices per square foot are expected to climb by approximately 1.4% in the next 12 months. 20% of those surveyed thought that a correction would take place in response to the superheated growth in prices witnessed in the past two years, while 25% saw strong growth continuing.

*Tenants demanding (and paying for) quality*

The primary risks seen in the market are high existing sales prices and low cap rates, with a large amount of investment capital seeking office properties in the Los Angeles Basin. The greatest opportunities are seen in Class B product and in medical office space. The most interesting trends observed were a sharp increase in tenant improvements (tenants want quality, and are increasingly willing to pay for extra improvements themselves), and strong growth among owner-users.



## Industrial

The Los Angeles Basin industrial market is the tightest it has been in decades. Vacancy rates have fallen to just 4% Basinwide, and into the 2% and 3% range in Los Angeles County - hyper-tight conditions. Most of the demand over the past two years has been for buildings for-sale, with a growing number of firms deciding to take advantage of low interest rates to buy space rather than to lease it. This has had a moderate dampening effect on the leasing side of business, and asking rental rates have climbed by "only 4.5%" in the past twelve months. At the same time, sale prices climbed by 19% and cap rates fell into the 6% range.

*Leasing activity expected to climb as interest rates increase*

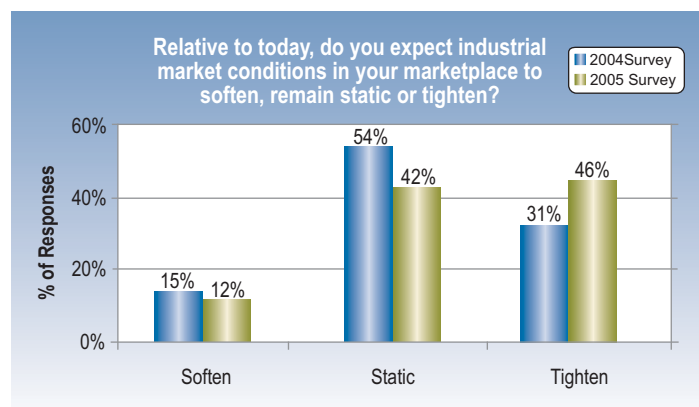
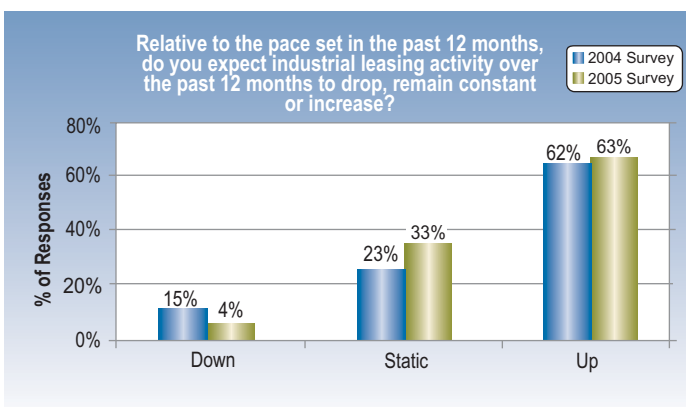
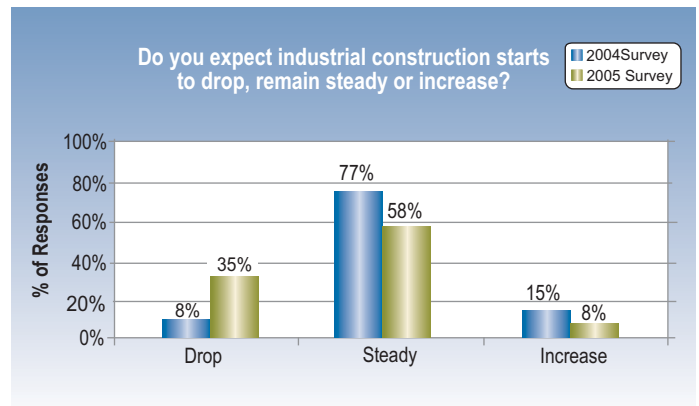
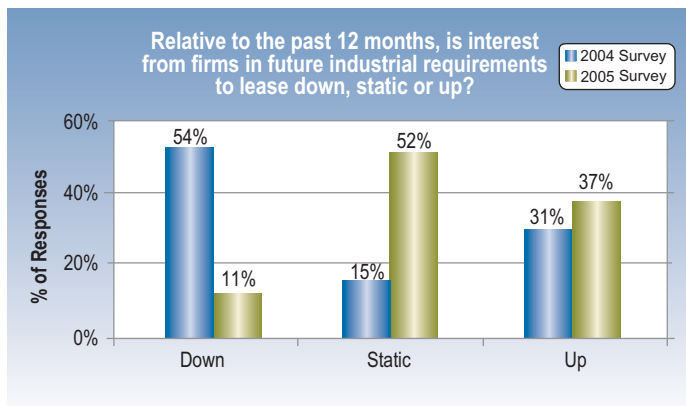
Interest in future industrial leasing requirements has picked up. 37% of those surveyed saw leasing interest as up; 12 months ago the percentage was 31%. More tellingly, just 11% saw interest as down; 12 months ago the percentage was 54%. The downturn 12 months ago was the result of a shift in interest from leasing to buying. It appears as though that shift has already

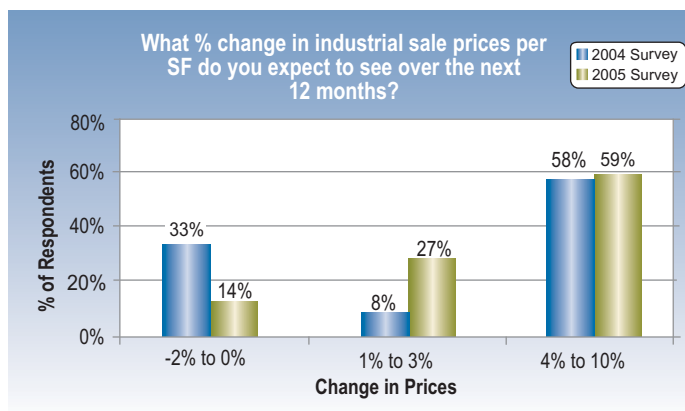
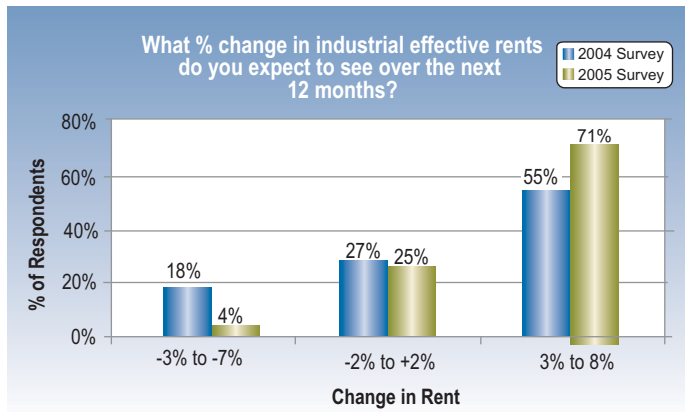
taken place. 63% of the brokers surveyed expect that demand for leasing space will pick up in 2006 (as interest rates climb). Interest in future requirements is reported to be particularly strong from logistics firms and distributors, and only moderate from manufacturers.

Despite very tight market conditions, construction activity is expected to remain steady. Lack of vacant, entitled land, particularly in Los Angeles and Orange Counties and in Western Riverside and San Bernardino Counties, is the primary reason.

Most brokers (88%) expect that market conditions will remain at their current tight levels or will tighten even further.

As a result of a continuation in tight market conditions (or even a tightening), 71% of the brokers surveyed expect effective rents to climb significantly (+3% to 8%) over the next 12 months.





Demand to buy industrial buildings remains intense, driven in large part by still low interest rates. Supply remains very limited. The majority anticipates continued strong growth in prices. The outlook is currently more bullish on prices than it was 12 months ago.

Risks cited by the brokers include very high prices, low cap rates and the risk of climbing interest rates. The greatest opportunities continue to be seen in small buildings.

## Retail

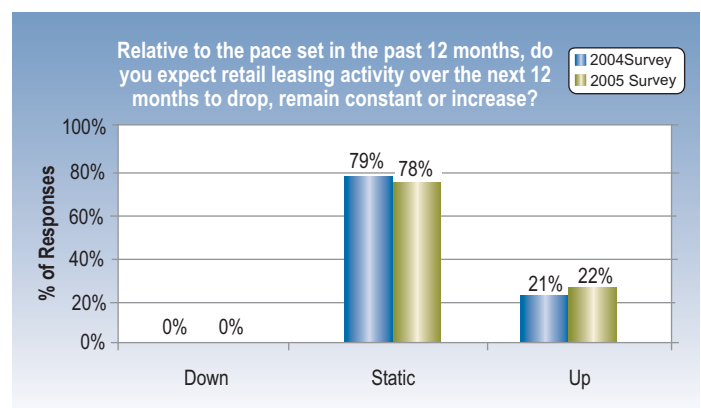
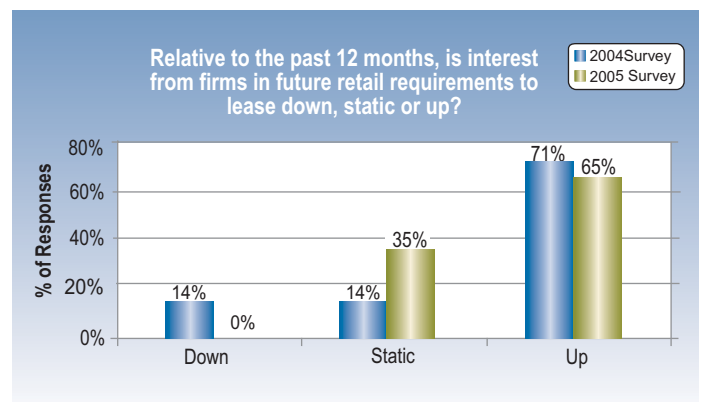
Demand for retail space in the Los Angeles Basin retail market has been very strong for the past three years and construction activity limited, particularly in existing urban areas. The market is very tight, with vacancy rates in urban areas in the 2% range and with rapidly climbing effective rent (up 5% in the past 12 months, on average). Retail centers have also emerged as a favorite among investors, driving up prices and reducing cap rates.

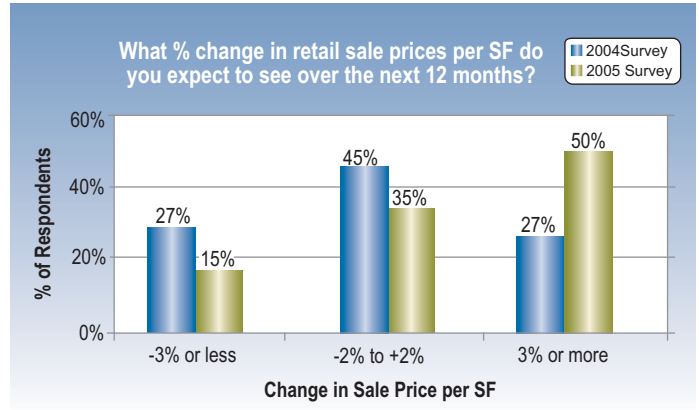
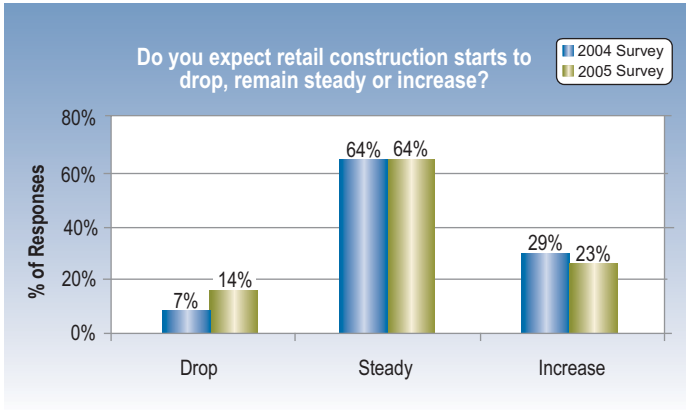
*Demand by retail tenants up from what already was a high level*

The results from the survey indicate that the market should remain tight into the foreseeable future. Interest in future requirements remains strong despite high rents. Today, 65% of the retail brokers surveyed say that interest by firms in leasing future space is up a high level and down only slightly from a year ago, when 71% indicated that interest was up.

The majority (78%) of the respondents expect that leasing activity over the next 12 months will maintain its current strong pace, and 22% expect an increase. Brokers continued to indicate that activity would be even higher if more space were available. None expect a slowing. Particularly strong demand is coming from restaurants (particularly fast food) and coffee houses.

Most (64%) of those surveyed anticipate that construction activity will remain steady at 2004 levels. The percentage expecting an increase in activity has dropped from 62% two years ago and from 29% a year ago to 23% today. Apparently, construction activity will remain relatively restrained, despite tight market conditions. Reasons for the limited activity





include a lack of vacant land, particularly in existing urban areas.

Most brokers anticipate that the market will remain healthy, with market conditions generally comparable to where they are today. Effective rents and sales prices, which are currently very high, are generally expected to remain firm. This suggests that 2006 will be another strong year for retail.

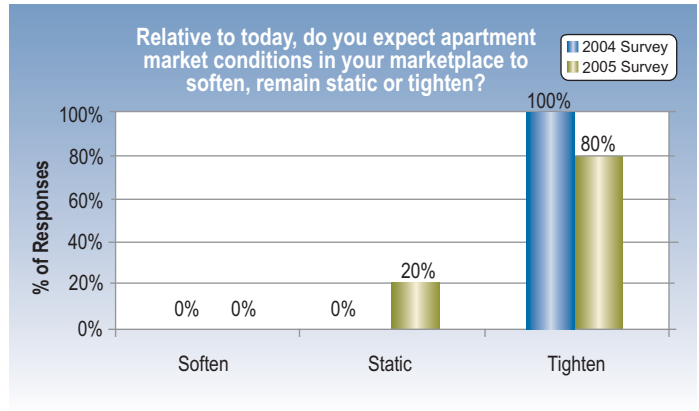
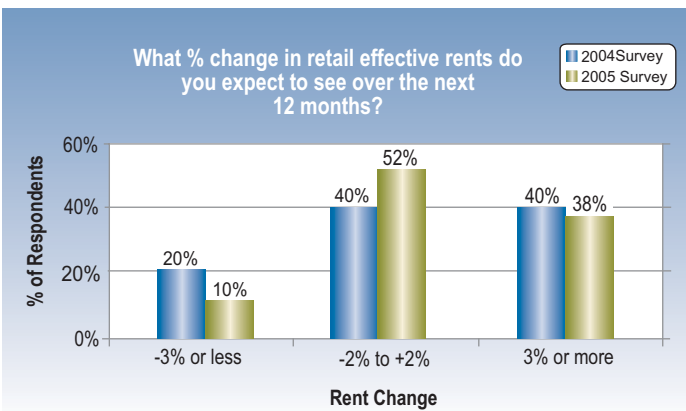
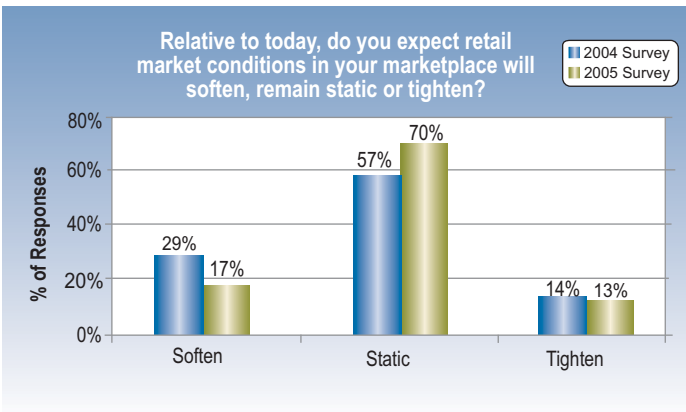
The major investment risks seen in the retail marketplace are prices that are high and cap rates that are low, with the possibility of a downward adjustment in prices if interest rates should climb. A number of respondents expressed concern about tenants being able to afford the high rents that landlords are asking. The greatest opportunities are seen in remodeling older centers, particularly in infill locations.

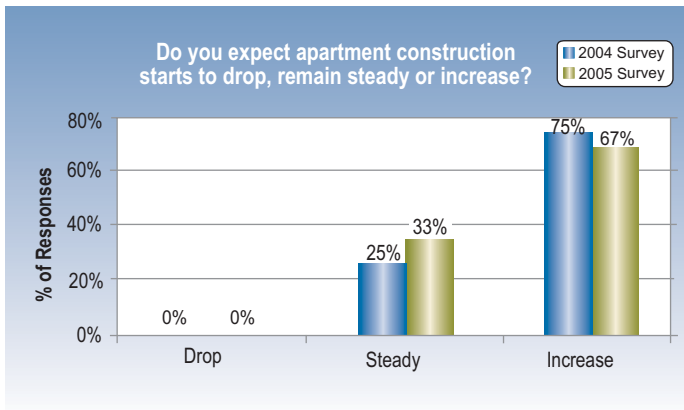
### Apartments

The Los Angeles Basin apartment market is also tight, with vacancies in urban areas in the 3% range and effective-rent growth of 5% in the past 12 months. Construction remains significantly below growth in demand, and investor interest remains intense, driving sale prices to record highs and cap rates to record lows (in the 4% range in some cases).

*Apartment market projected to continue to remain tight*

For the fourth year in a row, the broker survey projects tight market conditions for the Los Angeles Basin apartment market. Demand by tenants for rental units is expected to

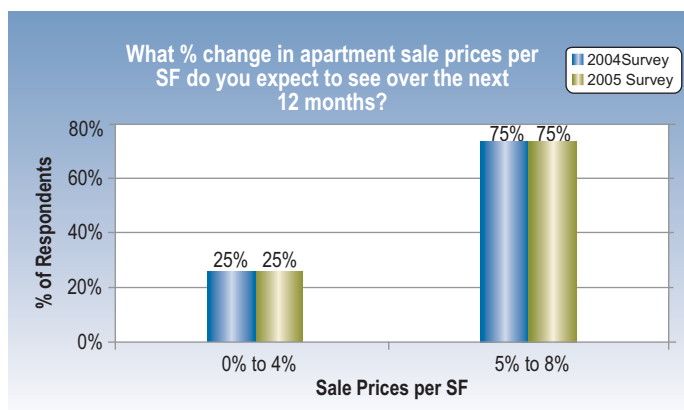
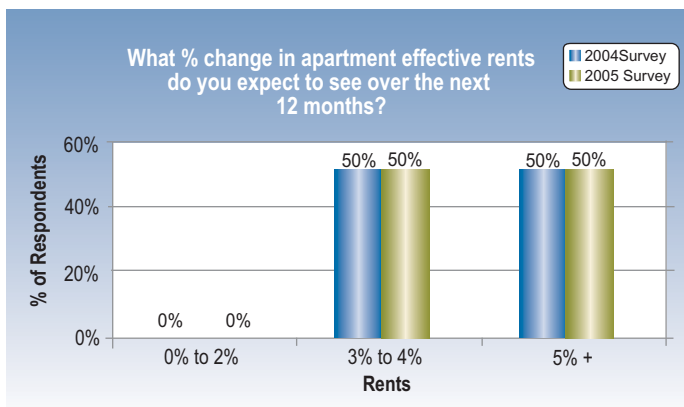




be strong, driven by strong household growth and by exceptionally high housing prices.

Construction activity is projected to pick up in response to the tight market conditions, but to still significantly lag growth in demand.

Rents are projected to increase by approximately 4.3%, and sale prices per square foot are projected to increase by



approximately 5.5% (on top of very strong rent and sales-price increases in recent years). The responses are quite similar to those witnessed in last year's survey.

As with the other property types, the major investment risks are seen as prices that are already high, cap rates that are already low, and interest rates that may climb. The greatest opportunities are seen in Class B and C product, where competition from new product will be limited and where prices are less inflated, and in adaptive reuse.

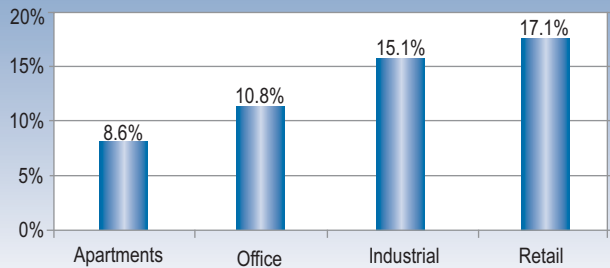
## SALE PRICES FOR COMMERCIAL PROPERTY CONTINUE TO SET NEW RECORDS

The median sales price for commercial properties in the Los Angeles Basin has continued to grow at a pace that astounds many observers. **Retail** has led the way, with the median sales price of properties sold during Q2 and Q3 2005 averaging \$282 per SF. This is up 17.1% over Q2 and Q3 2004, and 174% over prices ten years ago (122% in inflation-adjusted dollars). This very strong growth has been fueled by low vacancy rates (in the 2% range in urban areas), high rents and a positive outlook (projected strong tenant demand and limited construction activity). It also has been fueled by a switch in attitude among investors from one that avoided retail a few years ago (based on concerns about too much turmoil within the industry) to one that now considers retail a prime opportunity. Retail real estate investment has also benefited from a number of trends that have positively impacted all property types in the Los Angeles Basin - low interest rates, a perceived lack of opportunities in alternative investments, and the view that the Los Angeles economy is entering a growth cycle. Cap rates have fallen to just 6.3%, on average.

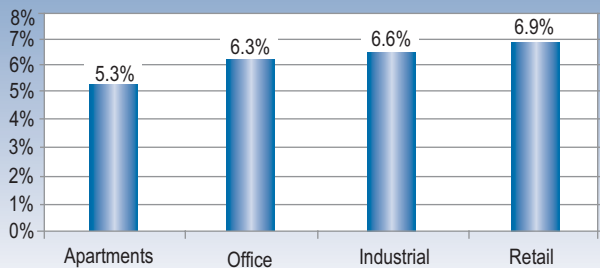
*Retail sale prices up 17% in past 12 months.*

Sale prices for **industrial** properties sold in Q2 and Q3 2005 averaged \$107 per SF, up 15% over Q2 and Q3 2004 and 168% over prices ten years ago (+119% in inflation-adjusted dollars). Prices were particularly high in Orange County at \$147 per SF, and particularly for small buildings (under 10,000 SF), where they exceeded \$200 per SF. The strong demand for industrial buildings has been driven by a combination of investors and owner-users. Cap rates averaged just 6.6%.

% Growth in median sale prices in past 12 months Los Angeles Basin



Current average cap rates Los Angeles Basin



Following the dot-com crash of late 2000 and 2001, **office** had fallen out-of-favor among most investors. However, now that the market is tightening once again, it is now in-favor, and product is hard-to-find. Sale prices for properties sold in Q2 and Q3 2005 averaged \$195 per SF, up 10.8% over a year ago and 150% over ten years ago (102% in inflation-adjusted dollars). A growing number of transactions for premier buildings have taken place at prices exceeding \$350 per SF. Cap rates have fallen to 6.9% -- higher than that for other property types, but much lower than the long-term average (9.3%, 1990 to 2004) for office properties.

**Apartments** in the Los Angeles Basin have been in-favor among investors for quite some time now, with growth in value of 20% per year 2002 through 2004. That pace has since slowed, with growth of "only 8.6%" from Q2 and Q3 2004 through Q2

*Apartment cap rates  
a low 5.3%*

and Q3 2005. Prices for apartments are now quite high, at \$134,700 per unit. Cap rates are extremely low, averaging just 5.3%. These high prices and low cap rates may temper future appreciation some, but the outlook is still quite positive with growth in supply greatly lagging growth in demand, and for-sale housing affordability in the Los Angeles Basin at record lows.

#### MEDIAN SALE PRICE PER SF Q2 and Q3 2005

##### Office

Ventura County	\$161
Los Angeles County	\$196
Orange County	\$199
San Bernardino/Riverside Counties	\$163
Weighted Average*	\$195

##### Industrial

Ventura County	\$99
Los Angeles County	\$99
Orange County	\$147
San Bernardino/Riverside Counties	\$88
Kern County	\$57
Weighted Average*	\$107

##### Apartments (price per unit)

Ventura County	\$115,800
Los Angeles County	\$139,100
Orange County	\$154,800
San Bernardino/Riverside Counties	\$97,200
Weighted Average*	\$134,700

##### Retail

Ventura County	\$323
Los Angeles County	\$290
Orange County	\$326
San Bernardino/Riverside Counties	\$214
Weighted Average*	\$282

\*Weighted by dollar volume of transactions

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Office Manager: Britany Jordan

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Bakersfield, California 93301  
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Branch Manager: Eric Powers  
Office Manager: Katherine McClain

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Branch Manager: David Powell  
Office Manager: Zinah Scott

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Office Manager: Debra Foreman

## **WEST LOS ANGELES**

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Branch Manager: Rick Gold  
Office Manager: Eileen Mahoney



The logo for NAI Capital features the letters 'NAI' in a bold, black, sans-serif font. The letter 'A' is stylized with a red triangle pointing upwards from its base. To the right of 'NAI', the word 'Capital' is written in a grey, sans-serif font.

# NAI Capital

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