Southern California Market Perspective

Spring 2005

Los Angeles

Orange

Riverside

San Bernardino

Ventura

Southern Kern Counties

NAI Capital

Commercial Real Estate Services, Worldwide.

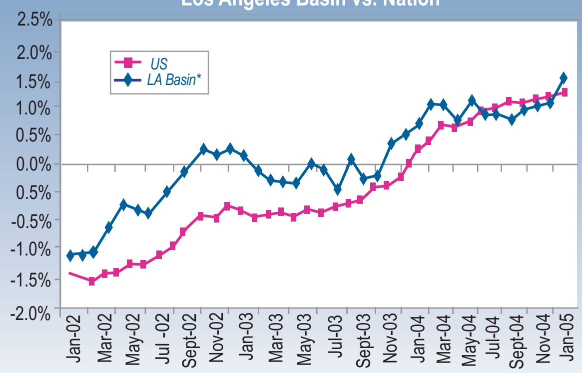
ECONOMIC AND DEMOGRAPHIC UPDATE FOR THE LOS ANGELES BASIN - SOLID EXPANSION TAKING PLACE

Total Employment Trends

Job growth accelerating

2004 was a good year for the Los Angeles Basin economy[1]. The area added 109,000 jobs, for growth of 1.5%. And the rate of growth accelerated in early 2005. For the 12-month period ending February 2005, the area added 147,000 jobs, for growth of 2.1%. This was a major improvement over 2003, when the region added just 20,000 jobs, for growth of 0.3%[2].

Change in Employment Prior 12-Months Los Angeles Basin vs. Nation

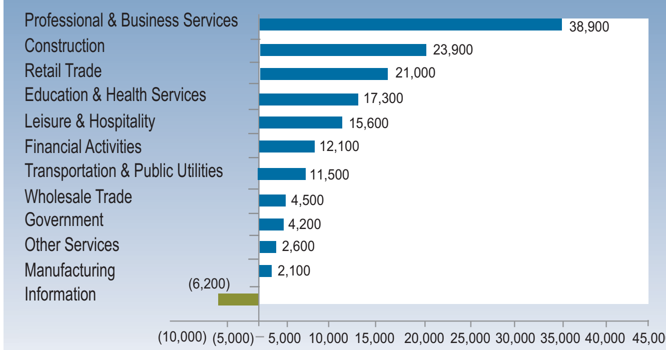


**Los Angeles, Ventura, Orange, San Bernardino, Riverside and Kern Counties Data based on a combination data from Economy.com and the California State Department of Economic Development for wage and salary employment and employment by place of work*

Driving the strong growth was Business and Professional Services (+38,900 jobs or 4%), followed by Construction (+23,900 jobs or 6.7%) and Retail Trade (+21,000 jobs, or 2.8%). The only sector that showed weakness was Information, which was dragged down by the loss of jobs in Motion Picture and Sound Recording, primarily in Los Angeles County, as well as in Telecommunications.

Strong growth was witnessed in all six counties. In terms of absolute growth, Los Angeles County led the way with 53,300 jobs, followed by Riverside/ San Bernardino Counties (+48,100 jobs) and Orange County (+36,400 jobs). In terms of percentage growth, the leader was Ventura County

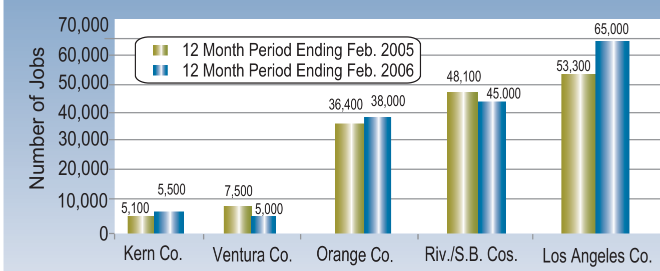
Change in Employment Feb 2005 over Feb 2004* Los Angeles Basin



**Based on data from CA State Department of Economic Development for employment by NAICs controlled to their estimates of employment by place of work data (from the household survey)*

% Change	
Construction	6.7%
Transportation & Public Utilties	4.5%
Professional & Business Services	4.0%
Retail Trade	2.8%
Financial Activities	2.7%
Leisure & Hospitality	2.3%
Education & Health Services	2.3%
Wholesale Trade	1.3%
Other Services	1.1%
Government	0.4%
Manufacturing	0.3%
Information	-2.3%

Historical and Projected Change in Employment*



**Source: Historical data: CA EDD; Projections NAI Capital. Data is for the household survey of employed residents. This is considered more reliable than the firm survey of wage and salary employees*

% Change 12 Month Period Ending	Feb. '05	Feb. '06
Riv./ S.B. Cos.	3.1%	2.9%
Orange Co.	2.4%	2.5%
Ventura Co.	1.9%	1.3%
Kern Co.	1.8%	2.0%
Los Angeles Co.	1.2%	1.5%

[1]Defined as the Counties of Los Angeles, Ventura, Kern, Orange, San Bernardino and Riverside.
[2]Based on preliminary data from the California State Economic Development Department for employment by place of residence (household survey) and by place of work (firm survey).

(+3.1% growth), followed by Riverside / San Bernardino (+2.9%) and Orange (+2.5%).

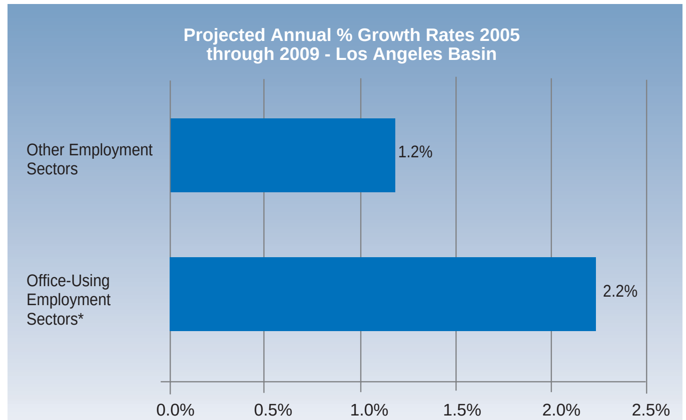
The outlook is for continued strong growth in the remainder of 2005 and into 2006. Interest rates remain relatively low, the nation's economy is still accelerating, businesses are adding capacity, and the consumer remains moderately confident. The primary worries are whether: (1) interest rates might rise sharply, particularly if inflation should pick up and/or if Asian countries should less enthusiastically purchase US Treasuries; and (2) recruitment of workers from other regions might falter, in light of the relatively high housing prices in the region.

We anticipate that growth will pick up in the information sectors, as recovery occurs in the entertainment and telecommunication industries. We also expect to see strong growth in bio-medical research, as a result of the recent passage of the California Stem Cell Bond Initiative, which will pump approximately $300 million per year into this effort. This is expected to add approximately 3,000 to 10,000 high-paying jobs per year in the Los Angeles Basin.

Office Employment Trends

Complete recovery in office market projected by year-end 2006

Economic projections indicate that jobs in office-oriented sectors (including business and professional services, information and finance, insurance and real estate) will grow at a much faster pace than jobs in non-office-oriented sectors. This will drive strong growth in demand for office space, estimated at approximately 6 million SF per year, on average, over the next five years. In 2005 and 2006, expansion years, net absorption of approximately 9 million per year is possible. This will cause vacancy rates to drop from their current level of 13% to single-digit levels within a year-and-a-half to two years, if the economy remains strong and construction remains restrained. As vacancy rates drop below 10%, rental rates can be expected to start climbing significantly. This is already starting to happen in some submarkets. As pointed out in our Year-End Market Report, tenants thinking about expanding should lock in rates now, before they start climbing once again. This will also present opportunities for the office investor, particularly in light of current low interest rates.



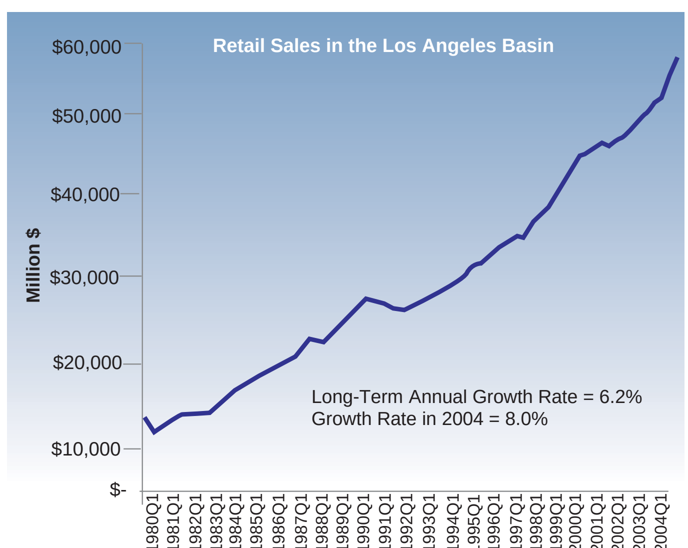
*Includes most employees in finance, insurance and real estate and in professional services, as well as a portion of employees of various other sectors, including communication and utilities, government and high-tech manufacturing

Retail Sales Trends

Retail sales up an 8% in 2004 - driving strong demand for retail and distribution space

Retail sales in the Los Angeles Basin grew by an estimated 8% in 2004, up from the long-term average for the area of 6.2% per year. This strong growth was due to the combination of:

- Strong household growth (estimated at 1.9% in 2004, or 106,000 households);
- Strong income growth (4.4% growth in 2004 in the median household income), including very strong growth among affluent households;



Estimates from Dept. of Commerce and Economy.com
Seasonally Adjusted Data

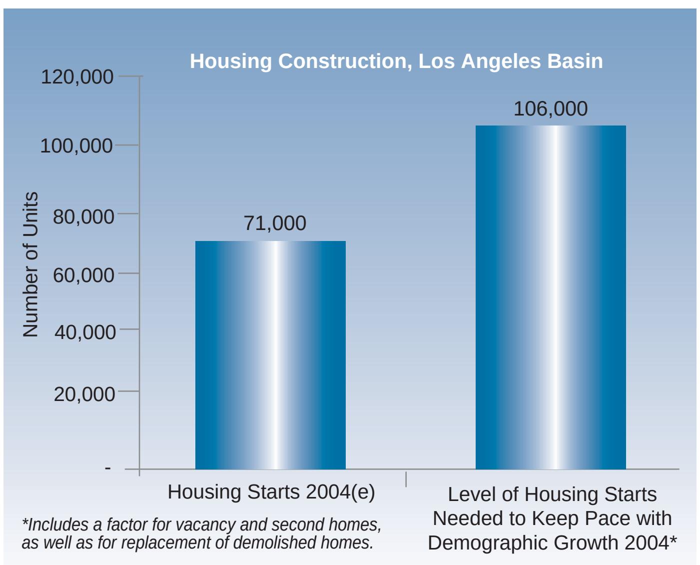
- Low interest rates and a wave of refinancing; and
- A buoyant consumer.

Household and income projections indicate that retail sales in the region should continue to grow by at least 6% per year on average, and by approximately 8% per year in expansion years (such as 2005 and 2006 are projected to be). This will continue to bring with it tremendous growth in demand for retail and distribution space in the Basin, and helps explain why market conditions in these sectors have been so healthy in recent years.

Household Trends

Housing supply still lagging demand

As previously mentioned, household growth in the Los Angeles Basin in 2004 was a strong 106,000 (+1.9%). This brought with it strong growth in demand for both for-sale and rental housing. Supply continued to lag growth in demand, which helps explain why home and apartment prices continued to appreciate so strongly in 2004[3]. These dynamics are projected to continue into the remainder of 2005 and into 2006, although supply is picking up, particularly in the Inland Empire.



[3]*Building permits for 97,000 units were issued. But historical experience indicates that this will result in a net addition of only approximately 71,000 units, with the difference due to demolition activity as well as the fact that some building permits never result in the completion of a housing unit, and some are for second homes.*

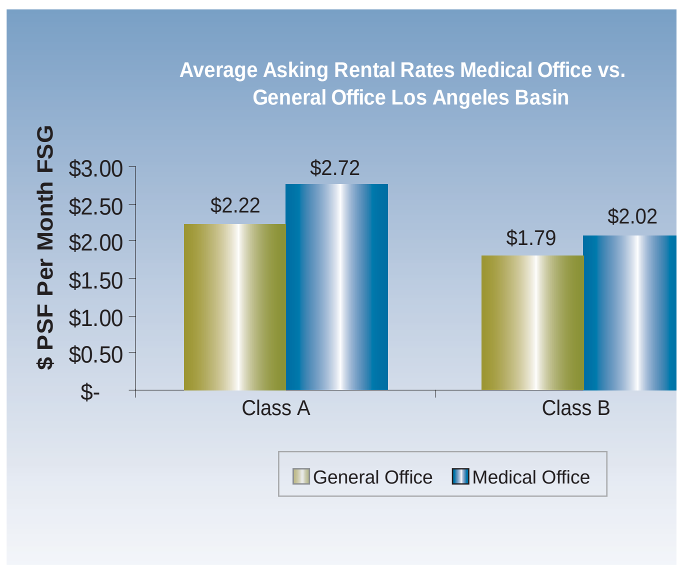
MEDICAL OFFICE BUILDINGS

Development and Investment Opportunities

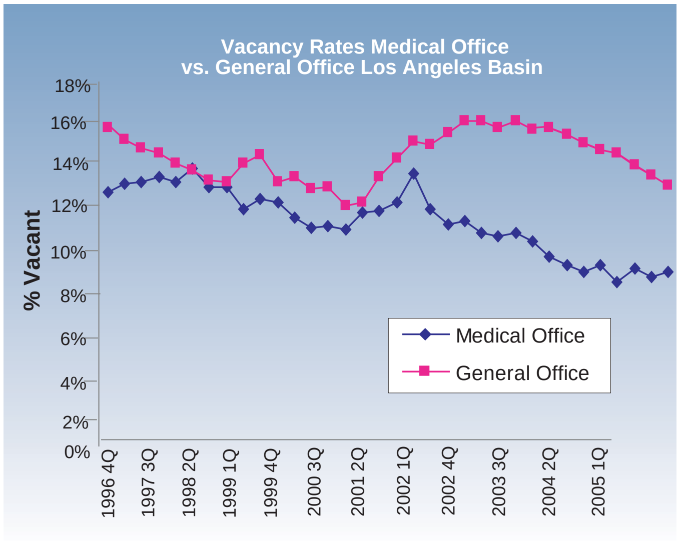
Healthy vacancy rates; high rental rates

One niche in the office market that has consistently outperformed all other segments has been the medical-office-building (MOB) segment[4]. Vacancy rates in MOBs in the Los Angeles Basin are currently a healthy 8.3% (vs. 13% for the general office market) and rental rates for Class A MOBs currently average $2.72 per square foot (full service gross), 22% higher than the average for general office Class A space ($2.22).

Importantly, vacancy rates for MOBs have historically run lower than vacancy rates for general office buildings. Over the past eight years, they have run an average of 3.4 percentage points below the levels for general office space. Reasons for this discrepancy include strong growth in demand for MOB space and restrained growth in supply. The MOB market is apparently not well understood by many developers, and the requirements (including high tenant-improvement allowances, high parking ratios, and locations near medical facilities) have warded off others.



[4]*MOBs are defined as office buildings with at least 50% of its space occupied by physicians or other ambulatory-health-care workers. Does not include space in hospitals.*



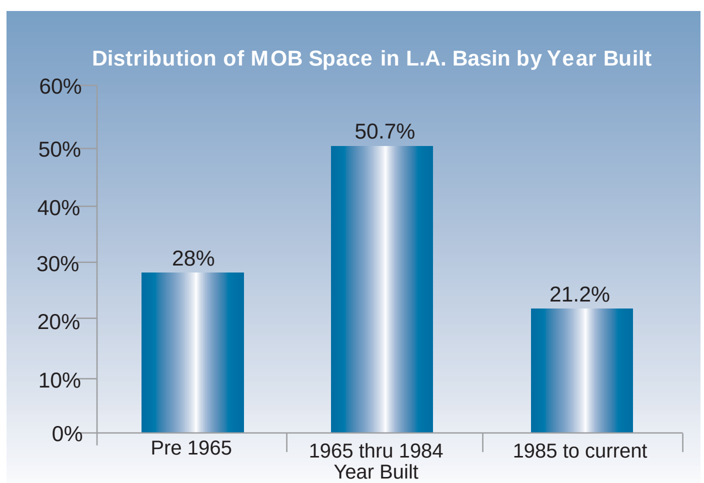
Demand for space in MOBs has, of course, been driven by growth among physicians and their assistants. Employment in ambulatory-health-care services (which includes workers in physician offices) has grown by 5,500 jobs per year 1990 - 2005 (+2.7% per year), representing a strong growth rate. In recent years (2001 - 2005), the growth rate has been nearly twice that, 10,100 jobs (+4.5%) per year. The outlook is for continued strong growth, given the large amount of population projected to be added in the Basin (2.4 million persons over the next ten years) as well as the movement of the baby-boom generation into their 50's and 60's. Employment projections indicate that approximately 7,700 jobs per year will be added in ambulatory-health-care sectors, for a growth rate of 3%. This could drive demand for as much as 800,000 SF per year in MOBs[5]. Note, however, that recent trends show a lower level of demand taking place, approximately 462,000 SF per year, representing growth in occupied space of 1.7% per year. Apparently, a significant percentage of ambulatory-health-care professionals are locating in non-MOB space, including in general office buildings, retail space and hospital-owned facilities. Assuming that this trend continues, a conservative projection would be growth in demand of approximately 500,000 SF per year in MOB space.

Employment in ambulatory-health-care services projected to grow by 3% per year

Currently, only 54,000 SF of MOB space is under-construction. As this space comes on-line, it will expand the base by just 0.2%[6]. 938,000 SF is planned. If all of this space is built, it would expand the base by 3.4% and represent a little less than two years of supply. This is a manageable amount, particularly considering that not all of the announced planned space will necessarily come on-line, and office buildings take one to two years to build. The outlook, therefore, is for continued healthy market conditions.

This background indicates that significant development and investment opportunities exist in the MOB niche. This is reinforced by the fact that the majority of the space in the area is moderately old, with 79% built pre-1985. There is a general shortage of modern MOB space in a number of markets within the Basin.

Generally restrained construction activity



Note, however, that developers and investors must take into consideration some of the unique characteristics of the MOB market. These include:

[5]*Calculated by multiplying 27.7 million SF (the current level of occupied SF in MOBs) by 3%. Total growth in space occupied by ambulatory health care professionals is projected at approximately 1.9 million SF per year (7,700 new workers per year x 250 SF per employee), but much of that growth (an estimated 57%) will likely take place in non-MOB space (i.e., in hospital-owned space, in retail buildings and in general office buildings). Data is for buildings in Los Angeles, Orange, San Bernardino, Riverside and Ventura Counties.*

[6]*In some communities, entitlement of MOB space is difficult to obtain, since these buildings tend to generate high levels of trips.*

- The tendency of MOBs to concentrate near each other and near hospitals. This concentration enables doctors to easily refer patients to each other, and to provide easy access to hospital and laboratory facilities.
- The requirement of MOBs to have a high level of parking. Five parking spaces per 1,000 SF is the minimum requirement, and six to one is preferred.
- The need to provide a high level of tenant improvement. Tenant improvement allowances for new Class A MOB space are running approximately $50 PSF - exceeding the $30 PSF average for general office. However, this cost is offset by the fact that turnover in MOBs is relatively low, and that rental rates are higher than in general office space.

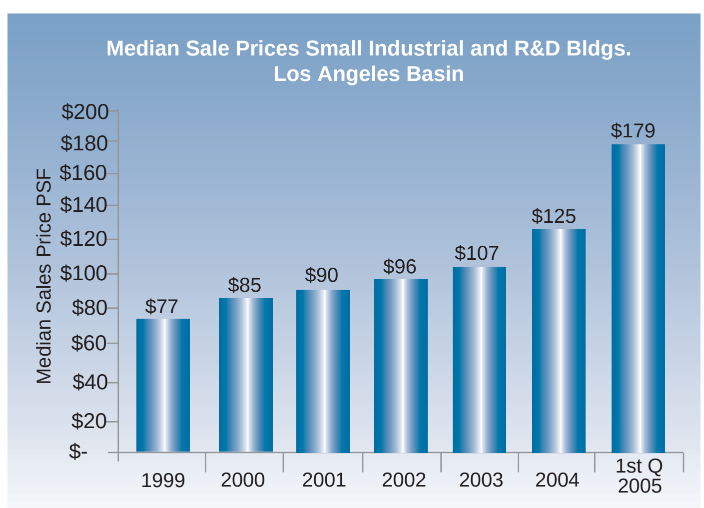
THE SMALL INDUSTRIAL AND R&D-BUILDING MARKET IS WHITE HOT

Prices up 43%

Sale prices for small industrial and R&D buildings are skyrocketing across the Los Angeles Basin. The median price for the 82 small buildings that sold in the 1st quarter 2005 was $179 per square foot, up 43% over the median for 2004. A buying fever has hit small users throughout the area, fueled by a combination of:

- **Lack of available product.** Vacancy rates in small buildings are currently very low, at 3.2%, down from 3.9% a year ago.
- **Climbing rental rates.** Rates were up 6% in 2004, and are projected to climb sharply in future years due to exceptionally low vacancy rates, strong demand and limited construction. Users are hoping to lock in their costs now by buying rather than leasing.
- **Still-low interest rates.** Small owner-users with good credit have found that they can buy units for just 10% down and interest rates near 6%. At 6%, monthly payments are approximately $0.97 PSF, while lease payments on the same property are approximately $0.95 PSF[7] .
- **High home-equity levels.** The recent run-up in home prices is enabling a number of small-business owners to refinance their home to pull out cash to make the down payment and to cover any negative carrying costs that may occur from purchasing a building, and to obtain a tax benefit by doing so.
- **Obtaining the advantages of ownership.** Ownership enables small business to control their property, including making any renovations they may want.
- **Steadily increasing property values.** When property values climb as much as they have in recent years, it stimulates a number of buyers "to act now before they climb any higher."
- **Lack of alternative investment opportunities.** Many small-business owners and investors are still wary of stocks and bonds.
- **Movement of the baby-boom generation into pre-retirement years.** Many small-business owners see buying their own building as a means to save for their retirement, with a property 100% occupied by a credit tenant - their own business.
- **An expanding economy.** A growing number of business owners consider this to be a good time to take on additional risk.

Buyers of these properties typically are entrepreneurs who live in the area and who own a firm with 5 to 15 employees. These firms are in a wide variety of sectors, including busi-



[7]*Based on purchasing a property at $180 PSF with 10% down and a 30-year loan.*

	MORTGAGE RATE					
	5%	6%	7%	8%	9%	10%
Mo. Interest Cost PSF @ 0% down	$0.75	$0.90	$1.05	$1.20	$1.35	$1.50
Mo. Payment PSF @ 0% down	$0.97	$1.08	$1.20	$1.32	$1.45	$1.58
Mo. Payment PSF @ 10% down	$0.87	$0.97	$1.08	$1.19	$1.30	$1.42
Rental rate on equivalent space 2005	$0.95	$0.95	$0.95	$0.95	$0.95	$0.95

Calculations based on $180 PSF and a 30-year-loan

ness consulting, engineering, retail, construction, printing, real estate, personal services, medical services, insurance, mortgage brokerage, manufacturing, travel and computer services.

Prices expected to level

Despite very high prices, properties for-sale are still hard to find. Current owners have witnessed the run-up in prices, and are reluctant to sell for fear of missing out on even more appreciation. Besides, most investment properties are producing a positive cash flow, and many owners don't know where they would re-invest the money if they were to sell. However, sellers could suddenly emerge if they sense the market is peaking.

The main question on the minds of most observers is how long will this phenomenon last? Our expectation is for a gradual leveling in prices.

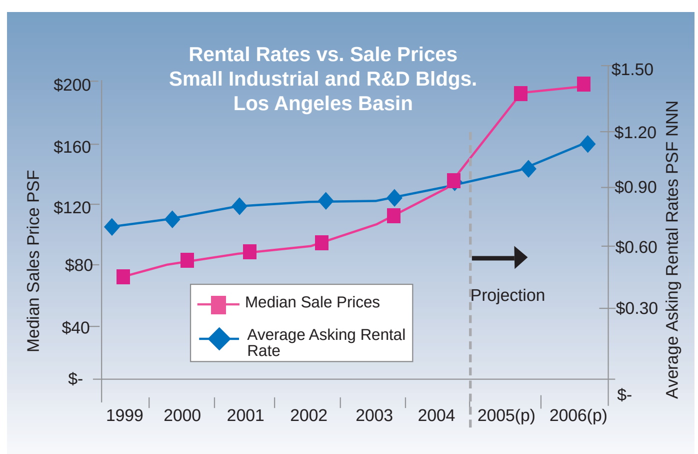
The Blue Chip Forecast predicts only a moderate increase in inflation and in T-Bill interest rates over the next two years. If this turns out to be accurate, mortgage rates would likely climb to no more than 7%. As shown in the table above, monthly payments on a $180 PSF property with a mortgage at 7% still stay generally near leasing costs. This would likely keep demand from owner users at a high level, albeit at a lower level than the frenzied demand of late. Should interest rates climb substantially above 7%, then leasing would be cheaper on an immediate-cash-flow basis, and owner-user demand would likely fall.

Demand from users of this space has been growing by 1.2 million SF per year on average 1999 to current, for growth in occupied space of 1.7% per year. Our expectation is that demand will be very strong for at least the next two years, driven by a large and rapidly growing economy, as discussed in the first article in this report, as well as strong growth among small businesses.

Despite very high sale prices, construction activity of small industrial and R&D buildings remains restrained. 1 million SF is currently under-construction, which, when complete, will expand the base by 1.4%. This will roughly equal growth in demand over the next six to nine months, and vacancy rates are projected to remain near current low levels. Construction is limited in many areas due to lack and expense of vacant land, difficult entitlement issues, and intense competition from residential developers for any vacant land.

Rents expected to climb sharply

As a result of the projected low vacancy rates and strong demand, rental rates appear likely to climb very sharply. We anticipate that they will grow by approximately 10% per year over the next two years. Assuming that the recent ramp-up in sale prices will level, this would diminish some the current discrepancy between sale prices and rental rates.



NAI Capital

Commercial Real Estate Services, Worldwide.

800.468.2618 • naicapital.com