



Market Perspective

Southern California

Spring 2006



Los Angeles

Orange



Riverside

San Bernardino

Ventura



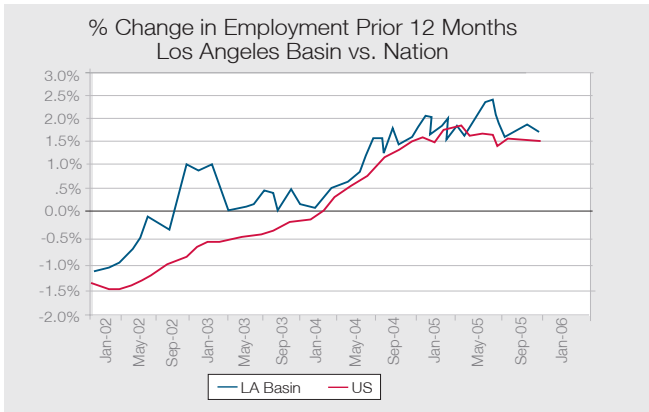
Southern Kern Counties

Economic and Demographic Update for the Los Angeles Basin - 2005 and 2006: As Good as It Gets

Total Employment Trends

These are very good times for the Los Angeles Basin economy.¹ For the 12-month period ending February 2006, the area added 147,000 jobs, for growth of 1.8%. And the rate of growth remained strong in early 2006.²

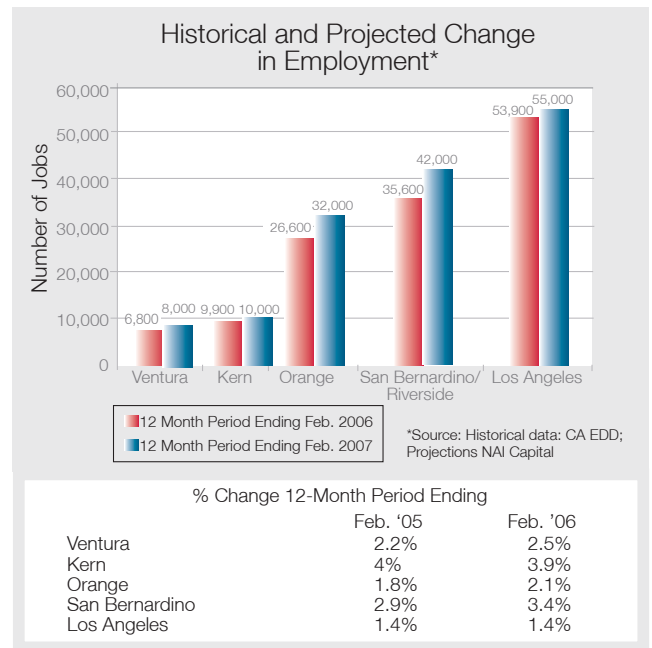
147,000 jobs added in the past 12 months



Driving the strong growth was Construction (+30,300 jobs or 8%), followed by Business and Professional Services (+27,000 jobs or 2.7%) and Leisure and Hospitality Services (+17,700 jobs, or 2.5%). The only sector that showed weakness was Manufacturing, which continued its 50-year trend of shedding employment (this trend has also been taking place nationwide). Information (which includes Motion Pictures and Sound Recording, as well as Telecommunications and Computer Services) finally stopped its downward slide.

Strong growth was witnessed in all six counties. In terms of absolute growth, Los Angeles County led the way with 53,900 jobs, followed by Riverside/San Bernardino Counties (+35,600 jobs) and Orange County (+26,600 jobs). In terms of percentage growth, the leader was Kern County (+4% growth), followed by Riverside /San Bernardino (+2.9%) and Ventura (+2.2%).

The outlook is for continued strong growth through the remainder of 2006. Interest rates remain relatively low, the nation's economy is still strong, businesses continue to add capacity, and the consumer remains buoyant.



Of some concern, however, is the outlook for 2007. A growing number of economists are projecting a slowing in the growth rate (a slowing, not a shrinkage) in the year ahead. Reasons for the anticipated slowing include: (1) an up-cycle that will be five years old in 2007, and starting to mature; (2) expected continued increases in interest rates; and (3) shortages in the labor force, placing upward pressure on salaries. High housing prices will also place pressure on the local economy (both consumers and employers).

¹Defined as the Counties of Los Angeles, Ventura, Kern, Orange, San Bernardino and Riverside.

²Based on preliminary data from the California State Economic Development Department for employment by place of work (firm survey).

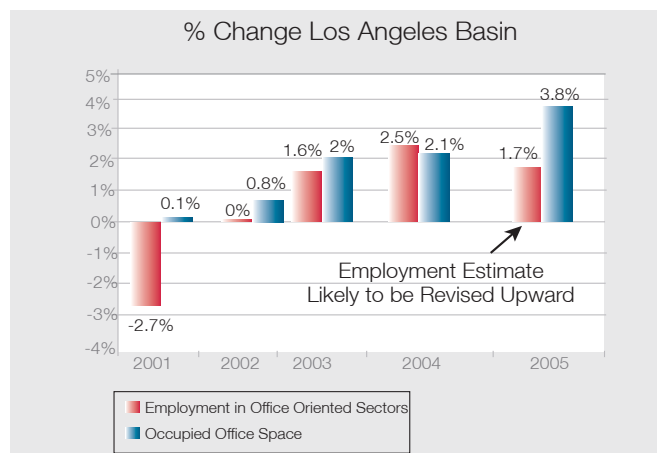
Office Employment Trends

Jobs in office-oriented sectors (including Business and Professional Services, Information and Finance, Insurance and Real Estate) grew by at least 29,200 employees (+1.7%) in the 12-month period ending February 2006.³ This drove very strong growth in demand for office space, and 11.9 million SF of office space was absorbed (nearly double the long-term average for the L.A. Basin of 6.5 million SF per year, 1985 to present). Also adding to the demand was a return of confidence among employers, who apparently have collectively decided that it is time to expand once again, particularly with rents at relatively low levels.

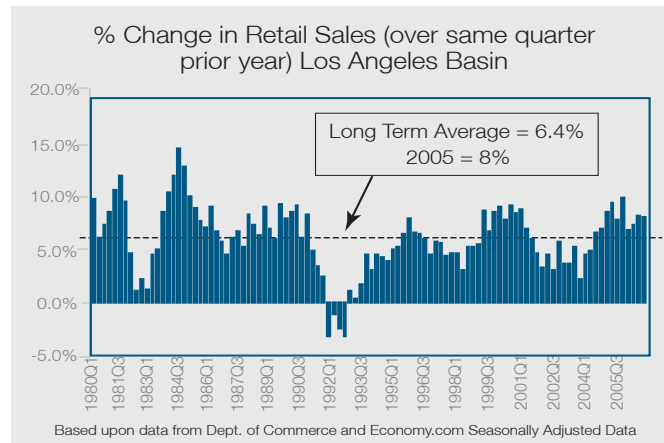
We anticipate that employment growth in office-oriented sectors will accelerate in the remainder of 2006, particularly among dot.com firms (who are coming back), computer services, entertainment and professional services. However, it is difficult to imagine that growth in demand for office space will continue at the frenzied pace of the past 12 months. Also, we will likely see a release in space from a number of mortgage banking firms, who are widely expected to be downsizing. A slowing to "merely very strong" growth rates in demand is anticipated, in the neighborhood of approximately 8 million SF in net absorption.

Approximately 6.1 million SF is currently under-construction (up very sharply from 2.8 million SF just three months ago). However, most of this space won't be coming on-line until mid-2007. Until then, vacancy rates will continue to drop sharply, approaching 8% Basinwide. In certain markets (West Los Angeles, the Tri-Cities, the San Fernando Valley and Orange County), vacancy rates approaching 6% are possible. This is likely to lead to rent spikes in a number of areas. As pointed out in our Winter Market Perspective, tenants thinking about expanding should lock in space now. Opportunities will also exist for the office investor, particularly in light of still-low interest rates.

Rent spikes by year-end expected



³Preliminary data from Ca. State Economic Development Department. Likely to be revised upward.



Retail Sales Trends

Retail sales in the Los Angeles Basin grew by an estimated 8% in 2005, the same as in 2004, and up from the long-term average for the area of 6.4% per year. This strong growth was due to the combination of:

Retail sales remain robust

- Strong household growth (estimated at 1.8% in 2005, or 101,000 households);
- Very strong income growth (5.7% growth in 2005 in the median household income), including very strong growth among affluent households;
- Still relatively low interest rates and a wave of refinancing; and
- A buoyant consumer.

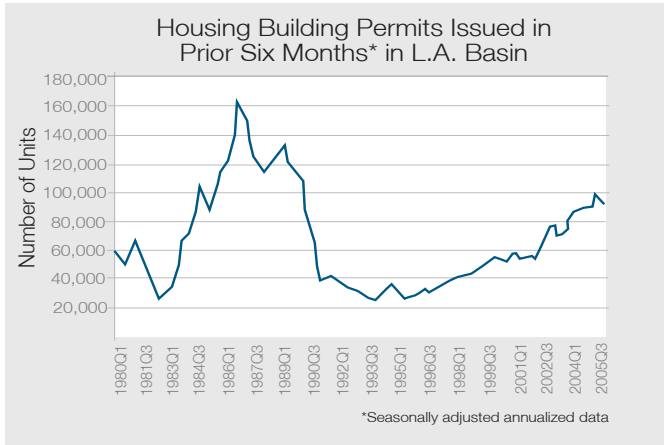
Most of these factors will continue to be in play during the remainder of 2006, and retail sales in the region should grow by approximately 6% to 8%. This will continue to bring with it very strong growth in demand for retail and distribution space in the Basin. A slowing in 2007, however, appears likely, particularly if interest rates should climb significantly.

Household Trends

As previously mentioned, household growth in the Los Angeles Basin in 2005 was a strong 101,000 (+1.8%). This brought with it strong growth in demand for both for-sale and rental housing, and demand continued to outstrip supply. Median home prices climbed by another 18%, and vacancy rates in apartments dropped to the low 3% range in Los Angeles and Orange Counties, and into the mid-4% range in the Inland Empire.

Building permits up, but still lagging demand

In the past six months, building permits were issued at an annualized pace of 96,000 units. Historical experience indicates that this



will result in a net addition of approximately 70,000 to 75,000 units in 2006, 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. Also, some of these permits are for second homes. Given the fact that the Basin is adding approximately 100,000 households per year, supply will continue to lag behind demand, particularly in Los Angeles, Ventura and Orange Counties. This should help prevent a severe correction in the housing market, although a leveling in prices certainly appears warranted. Price increases have greatly outstripped growth in household income. The discrepancy between prices in the Los Angeles Basin and much of the rest of the U.S. has grown sharply, and mortgage rates are climbing. The apartment market appears poised to enter hyper-tight conditions, particularly given the growing trend of converting apartments to condominiums.

The only concern may be in the Inland Empire, where building permits climbed to an annualized pace of 57,000 units, a very high level even for that robust market. Also, the upward slope of the building-permit trend indicates that the development community is clearly responding to the opportunities presented by the new price structure in the Los Angeles Basin housing market.

What is Cheaper? Buying or Renting?

Even with the rapid price appreciation of recent years, perhaps surprisingly, it is still cheaper to own than it is to rent (if the value of mortgage amortization is taken into consideration). This is true for all three property types examined - a small Class B office building, a mid-sized Class B industrial building and a Class B apartment building, all within a mid-priced market within Los Angeles or Orange Counties.

Still cheaper to own than to rent

This is due to interest rates that are still at relatively low levels (6.5% rates are still available, as of the time of this writing). This helps explain why demand has been so strong for buildings for-sale, even though prices are at record highs.

Additional advantages of ownership include the locking in occupancy costs, control of the property, and potential (probable) long-term building appreciation. Disadvantages include some loss of flexibility, responsibility for building maintenance and cash-flow hits (down payment, mortgage amortization and transaction costs).

As long as interest rates remain relatively low, these dynamics will continue to place upward pressure on prices. We calculate the "tipping point" where ownership becomes more expensive than renting (given today's rents and sale prices) at interest rates of approximately 7.5% (varies by product type).

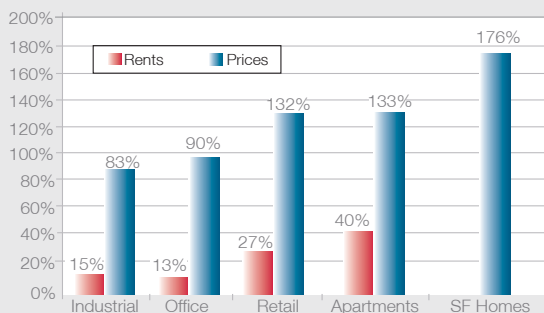
| | 8,000 SF Office Space | 75,000 SF Industrial Space | Apartment |
|---|--------------------------|-------------------------------|-----------|
| Sale price per SF/Unit | \$250. | \$88 | \$160,000 |
| Mo. Payment per SF/Unit @ 0% down | \$1.69 | \$0.59 | \$1,253 |
| Mo. Interest Cost per SF/Unit @ 0% down | \$1.35 | \$0.48 | \$1,040 |
| Mo. Payment per SF/Unit @ 20% down | \$1.35 | \$0.48 | \$1,037 |
| Mo. Interest Cost per SF/Unit @ 20% down | \$1.08 | \$0.38 | \$866 |
| Rental Rate on equivalent space 2006 | \$1.45 | \$0.57 | \$1,250 |
| Rent for office and industrial space is NNN. Property tax costs added to mortgage payments for apartment calculations. Assumes 25-year term and 6.5% interest rate. | | | |

Booming Sale Prices - What is Causing Them? How Much Longer Will it Last?

In the past six years, sale prices of real estate of all property types have climbed precipitously in the Los Angeles Basin. For example, the median sales price of industrial properties that sold climbed by 83% in 2005 over 1999; for office it was 90%; retail 132%; apartments 133%; and single-family homes 176%.

Prices up 83%
to 176% in past
six years

% Increase in Rents* and Sale Prices per SF or per Unit. 1999-2005 Los Angeles Basin



*Effective rents. Includes a factor for growth in occupancy (0.5% to 3%, depending upon property type)

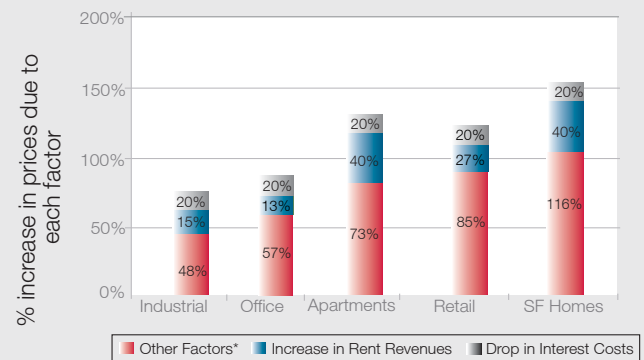
Reasons for the sharp increase in prices include:

- **A sharp drop in interest rates:** reducing interest costs by at least 20%, more if the shift to interest-only and adjustable instruments is taken into account.
- **Rent-revenue growth:** 11% to 43%, depending upon the product type (includes a factor for growth in occupancy).

The above two factors alone can account for price increases of 31% to 63%. Additional factors that influenced prices included:

- **Correction of prices** in the Los Angeles Basin that probably were under-valued in 1999 due to the lingering impact of the calamities that hit the Basin in the early 1990s, including a severe local recession, overbuilding, a flight of capital from real estate, a major earthquake and riots.
- **A shift in investor appetite** away from the stock market and other securities and toward real estate, in which they realized they were under-invested.
- **Expectations** that growth in rent revenues would accelerate in the Los Angeles Basin; and
- **Speculation.**

Factors Driving Price Increases 1999 - 2005 L.A. Basin



*Correction of under-pricing in 1999; shift in investor appetite to real estate; expectations of future strong rent-revenue growth; and speculation. Estimates generated by NAI Capital

These latter factors account for price increases of approximately 48% to 116%, depending upon product type, with the lowest increase associated with industrial and office (48% and 57% respectively), and the highest with retail and single-family homes (85% and 116%, respectively).

The outlook depends upon factors such as:

- **Future interest rates** - most economists expect a climb of approximately 75 to 100 basis points over the next two years, which would have a negative impact on interest costs of approximately 15%.
- **Future rent revenues** - our analysis indicates that very strong rent revenue (in the neighborhood of 10% to 20% total over the next two years) is likely.

The above two factors largely cancel each other out (with the expected increase in interest rates dampening prices, and the growth in rent revenues stimulating prices). If our projections in interest rates and in rent revenues are correct, this suggests "a soft landing" in price growth. Of course, should interest rates or market conditions vary significantly from our projections, prices would climb or fall accordingly.

An additional factor that will influence prices is investor appetite for real estate. This, in turn, depends upon expected returns in real estate vs. expected returns in alternative investment vehicles (such as stocks and bonds). Unfortunately, this latter factor is notoriously difficult to project. On the plus side, a large number of institutional investors still consider themselves under-allocated in real estate, and the amount of capital that they have is swelling due to contributions from the about-to-retire Baby Boom Generation. On the negative side, the large increase in prices in recent years attributed to sudden growth in investor appetite for real estate in the Los Angeles Basin suggests that significant risk exists (i.e., the investor appetite could disappear just as suddenly as it appeared). On this factor, each investor will have to make his or her own determination.

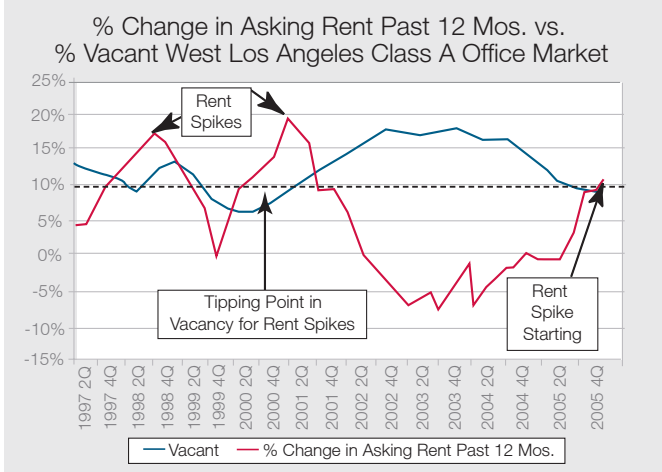
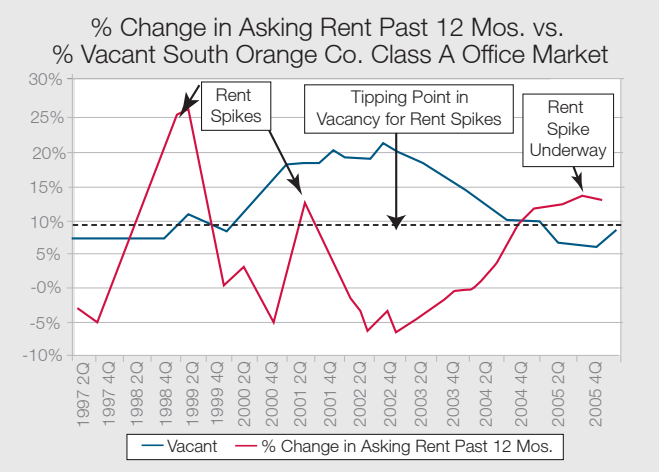
Rent Spikes Starting to Happen Once Again in the Office Market.

Rent spikes are starting to happen once again in West Los Angeles and South Orange County. In these markets, asking rents for Class A space have climbed in the past 12 months by 12% and 10% respectively. Reasons for the strong increase in rental rates include a drop in vacancy to a low level (they are at 7.9% in West LA and at 7.7% in South Orange County), coupled with strong demand. Firms are increasingly finding it difficult to find space that meets their needs in these prime markets, and landlords, who saw erosion in revenues 2001 - 2004, are raising their rental rates accordingly.

Rental rates up 12% in West LA and 10% in South Orange County in past 12 months

Historically, whenever vacancy has dropped below 8% in these markets and demand has been strong, a rent spike has occurred. The last time this occurred was in the late 1990s, when rental rates climbed by 26% in South Orange County and by 20% in West Los Angeles in one 12-month period. Since vacancy in these markets is projected to drop even further over the next 12 months, and since demand is also projected to remain strong for at least another 12 months, rent spikes in the 15% to 25% range once again are possible.

Other office markets that appear on the verge of entering rent-spike territory include the Tri-Cities Area (Glendale, Pasadena and Burbank), North Orange County, and the San Fernando Valley.



Serving the greater Los Angeles market with fourteen offices across six counties

ENCINO-Corporate Office

16001 Ventura Blvd., Suite 200
Encino, California 91436
(818) 905-2400 • FAX (818) 905-2425

BAKERSFIELD

1712 19th Street, Suite 220
Bakersfield, California 93301
(661) 864-1000 • FAX (661) 864-1011

COMMERCE

400 Citadel Drive, Suite 150
Los Angeles, California 90040
(323) 201-3600 • FAX (323) 201-3636

NEWPORT BEACH

4650 Von Karman Avenue
Newport Beach, California 92660
(949) 854-6600 • FAX (949) 854-7378

ONTARIO

3281 East Guasti Road, Suite 225
Ontario, California 91761
(909) 945-2339 • FAX (909) 945-2338

PASADENA

225 South Lake Avenue, Suite 1170
Pasadena, California 91101
(626) 564-4800 • FAX (626) 564-4846

SIMI VALLEY

1200 E. Los Angeles Ave., Suite 205
Simi Valley, California 93065
(805) 522-7132 • FAX (805) 522-1361

SOUTH BAY

970 W. 190th Street, Suite 100
Torrance, California 90502
(310) 532-9080 • FAX (310) 327-6259

TEMECULA

43460 Ridge Park Drive, Suite 200
Temecula, California 92590
(951) 719-8466 • (951) 719-8467

VALENCIA

27971 Sloan Canyon Road
Castaic, CA 91384-2594
(800) 468-2618

VENTURA COUNTY

300 Esplanade Drive, Suite 1660
Oxnard, California 93036
(805) 278-1400 • FAX (805) 278-1414

WEST LOS ANGELES

1640 South Sepulveda Blvd., Suite 500
Los Angeles, California 90025
(310) 440-8500 • FAX (310) 440-8525

WESTLAKE VILLAGE

2555 Townsgate Road, Suite 320
Westlake Village, California 91361
(805) 446-2400 • (818) 865-1200
FAX (805) 446-2401

WESTMINSTER - Pacific Rim Division

15496 Magnolia St. Suite 108
Westminster, CA 92683
(800) 468-2618



800 468 2618 ■ naicapital.com

