

Market Perspective

Southern California

Fall 2007



- Los Angeles
- Orange
- Riverside
- San Bernardino
- Ventura
- Southern Kern Counties

Sixth Annual NAI Capital Broker Survey

The **industrial**, **retail** and **apartment** markets in the Los Angeles Basin remain exceptionally tight, and the **office** market also is tight in most submarkets. Rental rates are up strongly for all property types, and rent spikes have taken place in some segments (20% growth in rents in West Los Angeles office, for example). Sale prices per square foot (SF) have hit record highs and cap rates remain low. However, a slowing in demand has been seen in recent quarters, and many are concerned that a correction will soon take place.

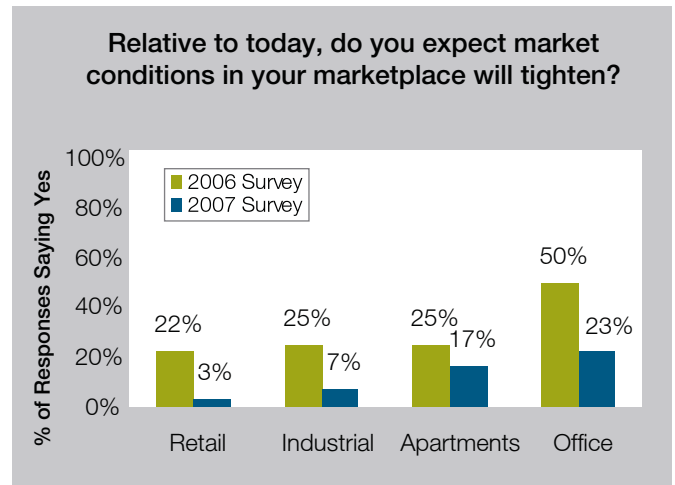
In order to provide insight to this and other real estate issues, we have once again conducted a survey of NAI Capital brokers about what they are seeing in the marketplace. As pointed out in previous survey reports, the brokers at NAI Capital are among the first to spot a trend in the marketplace. They have day-to-day exposure to a wide variety of players—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 have since repeated the survey annually. Those surveys have 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.

Generally less positive outlook than twelve months ago

In the Fall of 2007, we repeated that survey, and present our findings to you in this report. The major findings from this survey include:

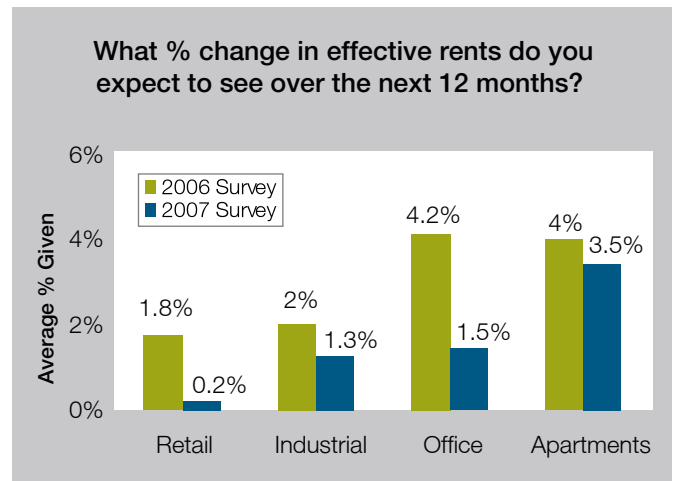
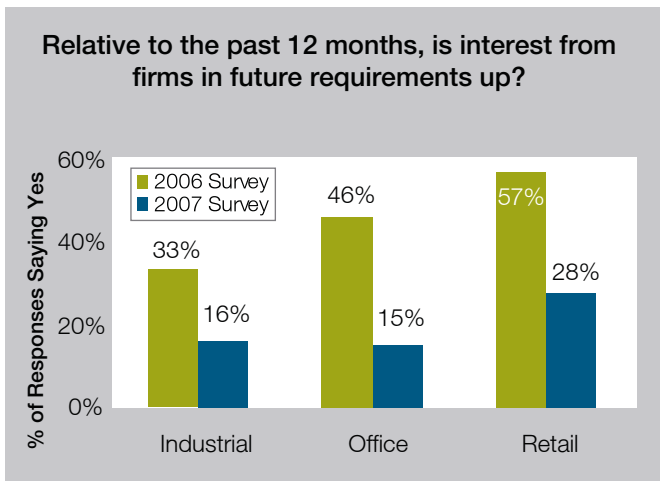
- Interest in future **office** requirements appears to have peaked and a significant amount of space is being released by mortgage-finance firms in some areas, particularly in Orange County and parts of the San Fernando Valley. A large amount of construction activity is also underway in these markets. Vacancy rates there are projected to soften and the rent-spike of the past 12 months should come to a halt. The strong sales-price growth of the past 12 months



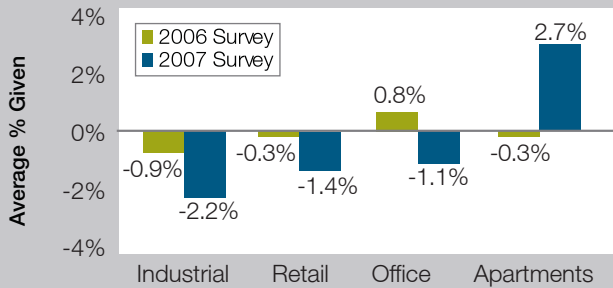
is expected to slow. However, some markets (for example, Central Los Angeles and the South Bay) have relatively small exposure to the downturn in the mortgage-finance industry and also have little or no construction activity. Market conditions there are expected to tighten even further in coming quarters.

- The outlook for the **industrial** market remains generally good, but a number of cautions cited in the 2006 survey were repeated in the 2007 survey: (1) vacancy rates are so low in Los Angeles and Orange Counties that it is hurting the amount of activity that can take place, and no further tightening appears possible; (2) a large amount of construction activity is underway in the East Inland Empire, and vacancy rates there are expected to climb over the next 12 months; and (3) sale prices per SF have reached such a high level that a modest correction in prices appears likely, particularly if interest rates should climb. A long-anticipated shift among users from buying properties to leasing properties is expected to take place in the next 12 months.
- Similar cautions are being voiced about the **retail** and **apartment** markets about the lack of room for any further tightening, and the possibility of a price correction, particularly in retail.

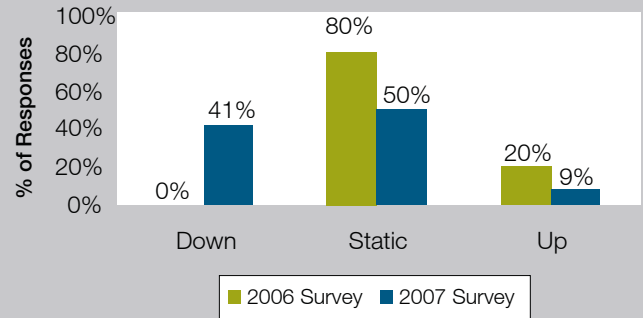
The greatest concern expressed was whether prices might take a hit if credit requirements should tighten and/or interest rates were to significantly climb. The greatest opportunities were seen among those with cash, being able to take advantage of any distressed sellers.



What % change in sale prices per SF do you expect to see over the next 12 months?



Relative to the pace set in the past 12 months, do you expect office leasing activity over the next 12 months to drop, remain constant or increase?



Detailed Findings

Office

Vacancy rates in the Los Angeles Basin office market bottomed in the 4th Q 2006 at 9.1%, and have since inched upward to 10%, due to the combination of moderate construction completions (4.4 million SF in the past 12 months, increasing the base by 1.2%) and a slowing in net absorption (occupied space grew by only 1.5 million SF in the past 12 months, or by 0.5%). This remains a low vacancy rate for the area, however, and rental rates have spiked, climbing by 12.3% on average, and by 20%+ in areas such as West Los Angeles and Burbank / Pasadena.

The Fall 2007 Survey indicates that a moderate softening in market conditions will likely continue into 2008, but that vacancy will remain in healthy territory in most areas. The very strong rent growth of the past 12 months is expected to slow.

Only 15% of the office brokers surveyed said that interest in future requirements is up, significantly lower than the 46% figure reported last quarter. The majority (55%) said that interest is on par with the (high) pace witnessed in the past 12 months, and 30% responded that interest was down.

Interest appears to have peaked

Interest in future office requirements from mortgage-finance and real-estate firms has plummeted. However, strong interest

continues from firms in entertainment, professional services (particularly law and medicine, as well as insurance), and, for the third year in a row, technology (including dot.com firms, as well as communications).

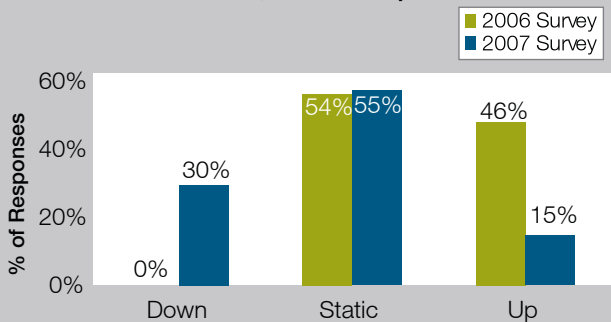
Half of the brokers surveyed expect that leasing activity over the next 12 months will remain constant, but this is closely followed by a large percentage (41%) that expects a slowing. This pattern is significantly less upbeat than that recorded 12 months ago.

Construction has increased, and 9.3 million SF is underway (up from 7.5 million SF underway 12 months ago and 3.3 million SF 24 months ago). When complete, the new space will expand the existing base by 2.6%, and represent approximately one-and-a-quarter-year's worth of supply under normal economic conditions, and more than that should the economy slow. 45% of those surveyed expect construction starts to slow, and another 45% expect starts to remain steady. Only 10% expect an increase in activity.

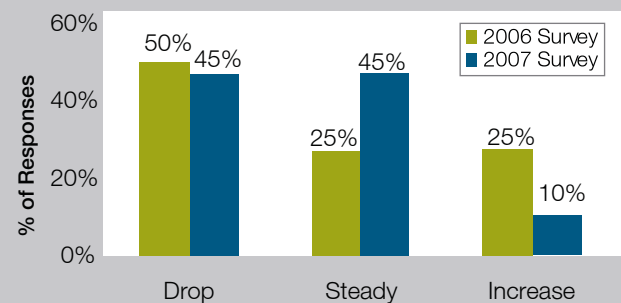
The survey showed a mix of opinions whether market conditions would soften (32%), remain static (45%) or tighten even further (23%). These largely followed geographical lines, with those in high-construction areas and with large concentrations of mortgage-finance firms (including Orange County and the San Fernando Valley) expecting a softening, and those in low-construction areas with relatively low concentrations of mortgage-finance firms (including the South Bay and Central Los Angeles) expecting a tightening.

A mix of outlooks, varying by submarket

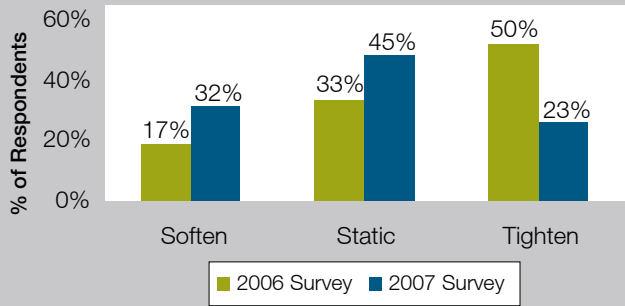
Relative to the past 12 months, is interest from firms in future office requirements to lease down, static or up?



Do you expect office construction starts to drop, remain steady or increase?



Relative to today, do you expect office market conditions in your marketplace will soften, remain static or tighten?

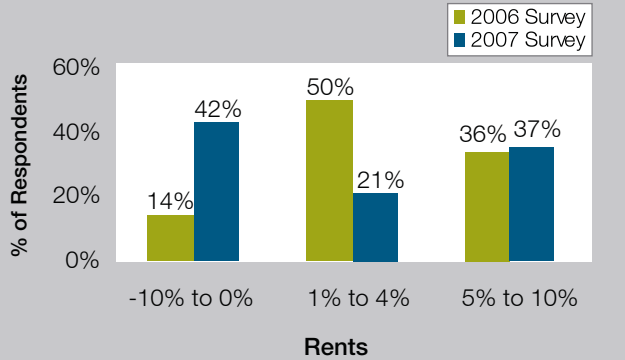


A similar pattern emerged regarding expectations for future rent growth, with a significant number (42%) foreseeing a drop in rental rates, nearly matched by another significant number (37%) seeing a strong increase in rates. None, however, predicted that the rent spike of 10%+ rent growth would continue.

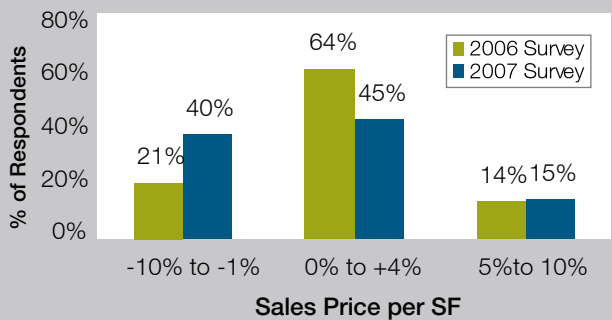
Sale prices per square foot, which have been skyrocketing over the past three years, are expected to flatten in the next 12 months (average projection = -1.1%). 40% of those surveyed thought that a correction would take place in response to the super-heated growth in prices witnessed in the

Sale prices per SF expected to flatten

What % change in office effective rents do you expect to see over the next 12 months?



What % change in office sale prices per SF do you expect to see over the next 12 months?



past three years, while 45% saw this growth moderating. Relatively few anticipated strong growth in prices to continue.

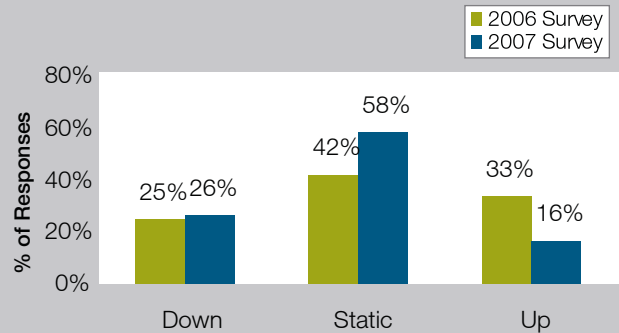
The primary risks seen in the market remain high existing sale prices and low cap rates, as well as potential softening in market conditions in some markets. The greatest opportunities are seen for those with cash, able to take advantage of opportunities offered by any distressed sellers. The most interesting trends observed were a movement among tenants to consolidate and more efficiently use their now-expensive space, strong demand for green buildings, and continued growth in office condos for sale.

Industrial

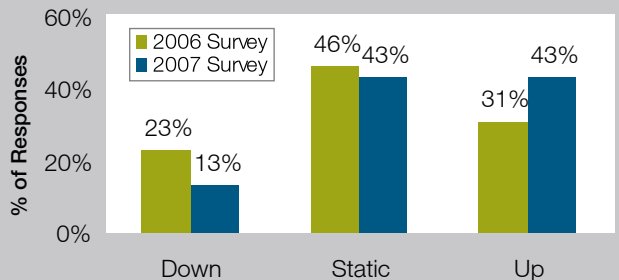
The Los Angeles Basin industrial market remains exceptionally tight. For the past three years, vacancy rates have hovered in the low 4% range Basin wide, and near 3% in Los Angeles County. Much of the demand over the past three years has been for buildings for-sale. This has had a moderate dampening effect on the leasing side of business, and asking rental rates have climbed by “only 9%” in the past twelve months. In the same time, sale prices climbed by 22% and average cap rates fell to the low 6% range.

Interest from owner-users in purchasing industrial buildings remains strong, but lack of supply continues to limit the amount of activity that can take place. Interest in future industrial leasing requirements remains moderate. 58% of those surveyed saw leasing interest as flat relative to the past 12 months, and a

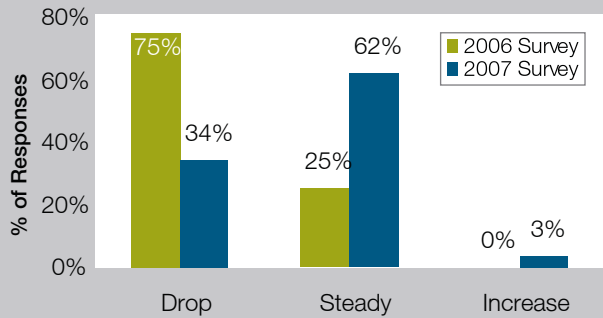
Relative to the past 12 months, is interest from firms in future industrial requirements to lease down, static or up?



Relative to the pace set in the past 12 months, do you expect industrial leasing activity over the next 12 months to drop, remain constant or increase?



Do you expect industrial construction starts to drop, remain steady or increase?



slightly higher percentage (26%) are witnessing a decrease in interest as compared to just 16% that are seeing an increase in interest. The responses were somewhat less bullish than the survey taken 12 months ago.

43% of the brokers surveyed expect that leasing activity in the next 12 months will be roughly the same as in the past 12 months, and 43% see an increase. The main reason for the expected increase in leasing activity is an anticipated slowing in purchasing activity by owner-users (due to now very high prices and a tightening of credit). Interest remains particularly strong from logistics firms and distributors, and weak from heavy manufacturers.

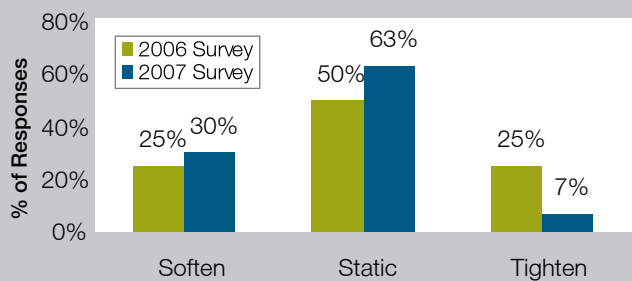
Current interest in future leasing requirements is only moderate

Currently, 31.3 million SF of industrial space is under-construction, with the vast majority of this space in the East Inland Empire. This is a large amount, which will expand the base by approximately 2% when completed, but is no greater than recent growth in demand. The brokers surveyed anticipate that future construction starts will remain low in Los Angeles and Orange Counties (due to lack of land), but high in the East Inland Empire.

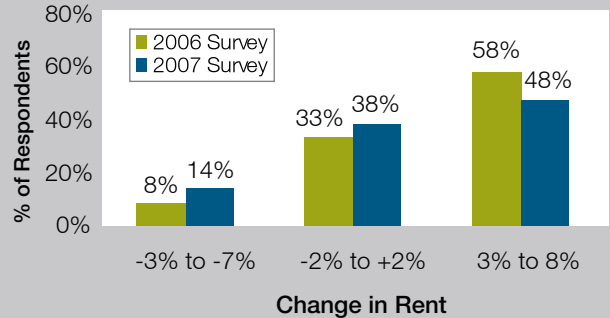
They also expect market conditions to remain generally tight in Los Angeles and Orange Counties and in the West Inland Empire, but to soften in the East Inland Empire.

Market conditions projected to remain tight in most areas

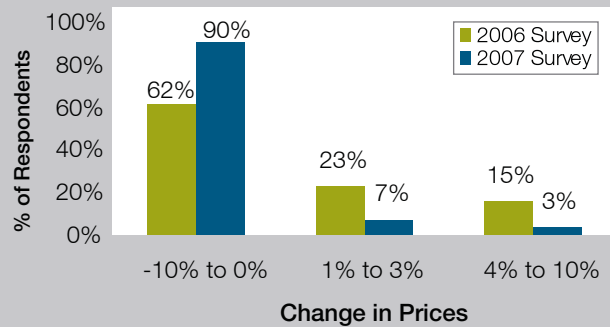
Relative to today, do you expect industrial market conditions in your marketplace will soften, remain static or tighten?



What % change in industrial effective rents do you expect to see over the next 12 months?



What % change in industrial sale prices per SF do you expect to see over the next 12 months?



As a result of a continued tight market conditions, nearly half (48%) of the brokers surveyed expect effective rents to climb significantly (+3% to 8%) over the next 12 months. However, a large percentage (38%) see a flattening, and 14% a moderate drop in rents. The average of the responses was 1.3% growth in rents.

Demand among owner-users to buy industrial buildings is expected to ease as interest rates climb and as potential buyers react to the very high prices being asked. The vast majority (90%) anticipate a modest to moderate drop in prices. The outlook is significantly more bearish on prices than it was 12 and 24 months ago.

Prices expected to correct slightly

Risks cited by the brokers include very high prices, low cap rates and the risk of climbing interest rates. As with office, the greatest opportunities are seen as with cash-flush buyers being able to take advantage of any distressed sellers.

Retail

Demand for retail space in the Los Angeles Basin retail market has been very strong for the past five 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 9% in the past 12 months on average). Prices per SF have climbed sharply in recent years, and cap rates have fallen to the high 5% range.

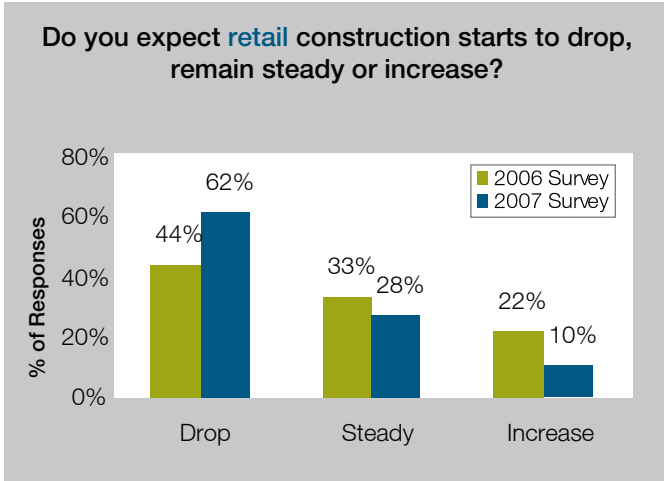
The brokers surveyed generally indicate that current interest in future requirements is generally steady (at a high level). In general, this is less bullish than the survey taken a year ago, when the brokers were seeing an increase in interest.

A similar pattern is seen regarding future leasing activity. A large percentage (42%) of the respondents expect that leasing activity over the next 12 months will remain constant, and those who see a slowing (31%) are roughly offset by those who see an increase (27%). Very strong demand continues to come from restaurants (particularly fast food) and from coffee houses.

Activity expected to remain relatively constant

There has been a recent strong up tick in construction activity. 19.7 million SF is currently underway which, when complete, will expand the base by 5.3%. Most of the brokers surveyed believe that this up tick is temporary. 62% of those surveyed anticipate

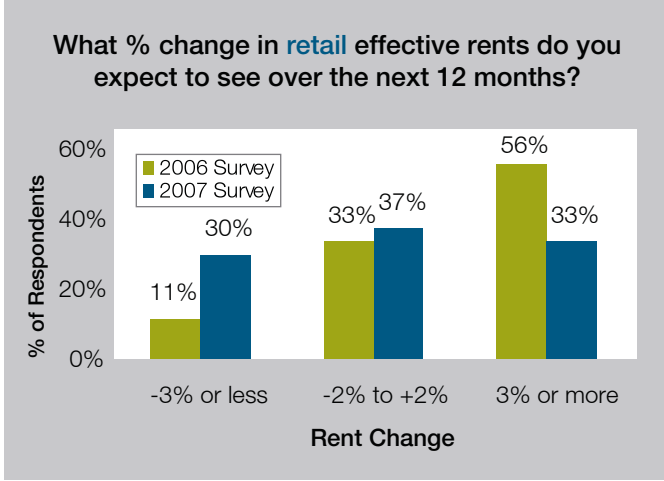
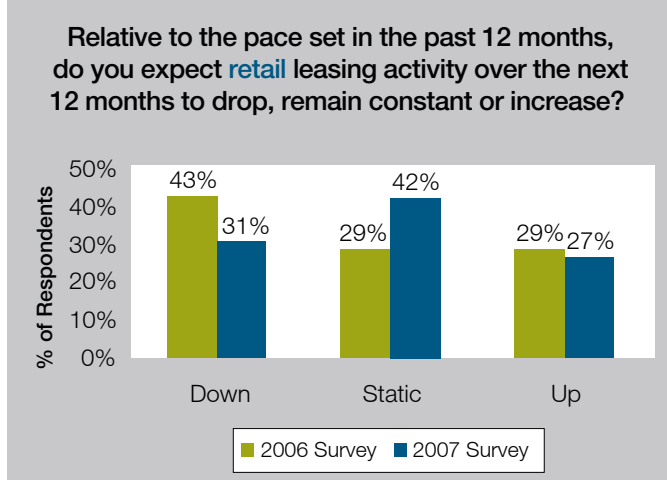
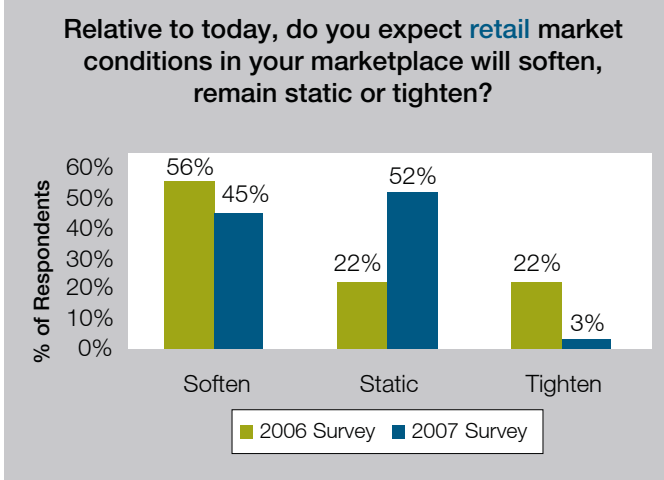
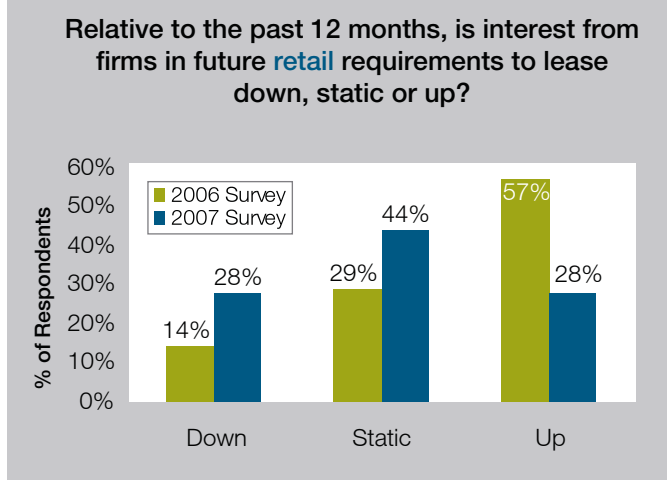
Current high level of construction activity seen as temporary



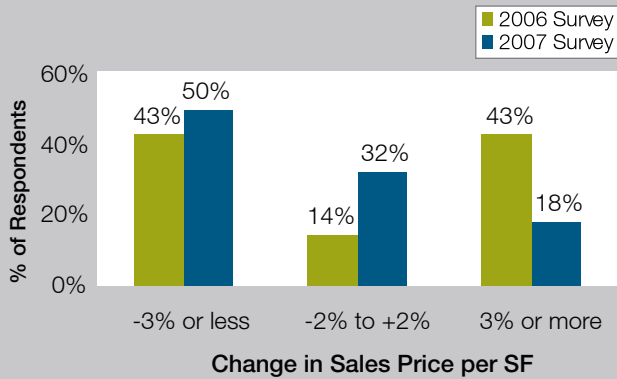
that construction activity will slow, and 28% believe it will continue. Only 10% believe it will increase.

The retail brokers are split 45% to 52% whether the market will soften or remain static and only 3% believe it will tighten. Reasons cited for a possible softening include the large amount of space under-construction, an anticipated slowing in economic growth, and a cooling off period from the superheated demand and rent growth of recent years. Reasons given for stabilization include a still strong economy and a large amount of existing pent-up demand for retail space within the Basin.

Modest rent growth is projected (just 0.2% on average), following the very strong growth in recent years.



What % change in retail sale prices per SF do you expect to see over the next 12 months?



Half of those responded expect sale prices per SF for retail properties to drop in the coming 12 months, and among those who expect some growth, most expect only modest growth. Reasons given for the more bearish outlook than 12 months ago include: the magnitude of the increase in prices in recent years; anticipated tightening in lending criteria; and an anticipated modest slowing in demand.

Small correction in prices expected

One of the most interesting new trends commented on is the growing number of mixed-use projects.

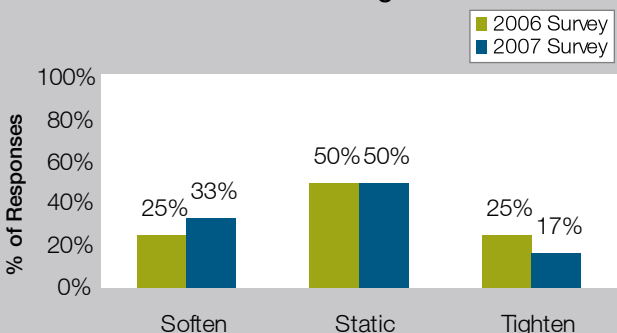
Apartments

The Los Angeles Basin apartment market is also very tight, with vacancies in urban areas in the mid-3% range and effective-rent growth of 5.5% in the past 12 months. Construction remains significantly below growth in tenant demand, and investor interest, while slipping some, still remains strong, keeping prices high and cap rates low (in the low 5% range, on average).

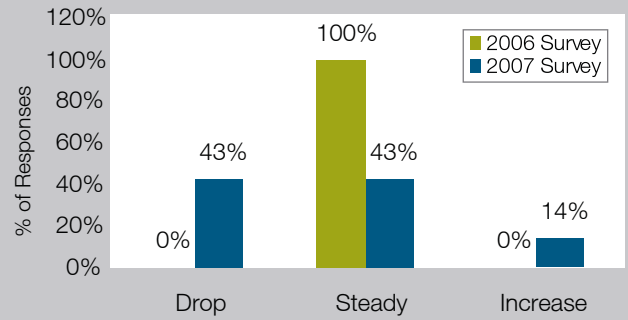
Half the brokers surveyed expect market conditions to remain static. The percentage projecting a tightening is down from last year, primarily because “the market is already very tight.” Demand by tenants for rental units is expected to be strong, driven by strong household growth and by a general loss of consumer confidence in the for-sale market.

Market projected to remain generally tight

Relative to today, do you expect apartment market conditions in your marketplace will soften, remain static or tighten?



Do you expect apartment construction starts to drop, remain steady or increase?



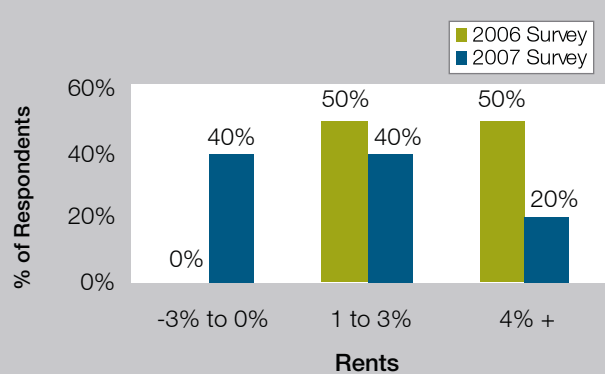
Construction activity is projected to remain steady, or even to drop some, and to continue to significantly lag growth in demand. Rents are projected to increase by approximately 3.5%, although 40% see a small downward correction.

Moderate growth in sale prices is expected (2.7% on average). This projected slowing in sale-price growth is due to prices that are already very high and cap rates that are already very low, as well as a concern that lending criteria will tighten.

Price growth projected to slow

Particularly significant opportunities are seen with senior living.

What % change in apartment effective rents do you expect to see over the next 12 months?



What % change in apartment sale prices per SF do you expect to see over the next 12 months?

