

ALLEN MATKINS | UCLA ANDERSON FORECAST

COMMERCIAL REAL ESTATE SURVEY

Allen Matkins

UCLAAnderson
FORECAST



Allen Matkins **FORECAST**

- A Increase faster than the rate of inflation
 - B Increase slower than or at the rate of inflation
 - C Stay the same
 - D Decrease
 - E N/A
9. If you invest in office space in Los Angeles, do you forecast that between 2009 and 2010, the vacancy rate in Los Angeles will
- A Increase
 - B Decrease
 - C Stay the same
 - D N/A
10. If you invest in office space in San Diego, do you forecast that between 2009 and 2010, the vacancy rate in San Diego will
- A Increase
 - B Decrease
 - C Stay the same
 - D N/A
11. If you invest in office space in Orange County, do you forecast that between 2009 and 2010, the vacancy rate in Orange County will
- A Increase
 - B Decrease
 - C Stay the same
 - D N/A

Welcome to the Latest Edition of the Allen Matkins/UCLA Anderson Forecast California Commercial Real Estate Survey and Index

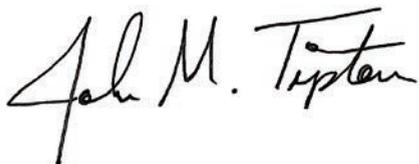
Allen Matkins and UCLA Anderson Forecast have partnered to create a Commercial Real Estate Survey and Index to better predict future California commercial rental and vacancy rates. This tool surveys supply-side participants – commercial developers and financiers of commercial development – for insights 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, industrial, retail and multi-family space in major California geographical markets. This twentieth survey covers the major Southern California and Bay Area markets for office, industrial, retail and multi-family 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 USA*, 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 65 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.

A handwritten signature in black ink that reads "John M. Tipton". The signature is written in a cursive style with a large, stylized initial "J".

John M. Tipton
Partner, Real Estate Department
Allen Matkins

CALIFORNIA COMMERCIAL REAL ESTATE SURVEY:

THE TRUMP SLUMP THAT WASN'T



When unexpected events occur, the perception of the future often changes. Certainly the election on November 8 qualifies as unexpected, at least in California. Given that California went heavily for Hillary Clinton, expectations ought to have changed for the worse. Yet, the Allen Matkins/UCLA Anderson Forecast survey, taken entirely after the election, shows no such discernible change. In part (perhaps large part) this may be due to the upward bump in consumer confidence and stock prices and in part because the regulatory environment in California is not likely to change much. All of the trends visible in the June 2016 survey continued into the December survey. Moreover, there are also no discernible changes in the speed of those trends. While the outlook for 2017 may look relatively good¹ the strong move towards online shopping, higher interest rates, a continued redefinition of the office environment and the dropping of fertility rates all transcend the election and the near term outlook as driving factors in commercial real estate.

In our analysis of the June 2016 Allen Matkins UCLA Anderson Forecast survey we observed the impending end to the boom in office building, particularly in the Bay Area.² In the same survey we also observed a slight movement away from retail space development and a softening in the multi-family market sentiment. These have continued and are reported below. The natural cycle in commercial real estate appears to continue to run its course somewhat independent of the presidential contest.

The Allen Matkins/UCLA Anderson Forecast Survey project compiles the views of commercial real estate developers with respect to markets three years hence. The three-year time horizon was chosen to approximate the average time a new commercial project requires for completion (though projects with significant environmental issues often take much longer). The panelists' views on vacancy and rental

rates are key ingredients to their own business plans for new projects, and as such, the Survey provides insights into new, not yet on the radar, building projects and it is a leading indicator of future commercial construction. For example, if a developer were optimistic about economic conditions in the industrial market of Silicon Valley in 2019, then initial work for a new project with an expected ready for occupancy date of 2019--a business plan, preliminary architecture, and a search for financial backing-- would have to begin no later than 2016. Although optimism does not always translate into new construction projects, this sentiment is a prerequisite for it.

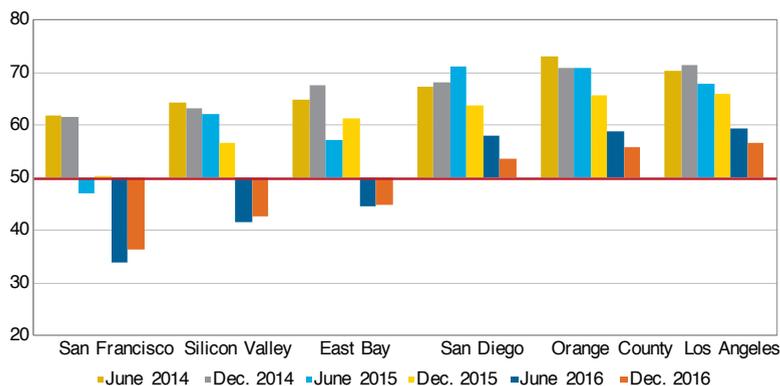
OFFICE SPACE MARKETS

More Evidence of Topping Out

The longest running survey is that for office space. We are now beginning to see the statistical power of the survey in forecasting turning points in office space development. For example, the Great Recession ended in July of 2009. However, the National Bureau of Economic Research (NBER) did not declare July 2009 to be the end of the 2008/2009 recession until their meeting over a year later.³ At least as far as office space markets in California, the forward-looking Allen Matkins/UCLA Anderson Forecast index of developer sentiment pointed to a turn in the Bay Area markets as early as mid 2009.

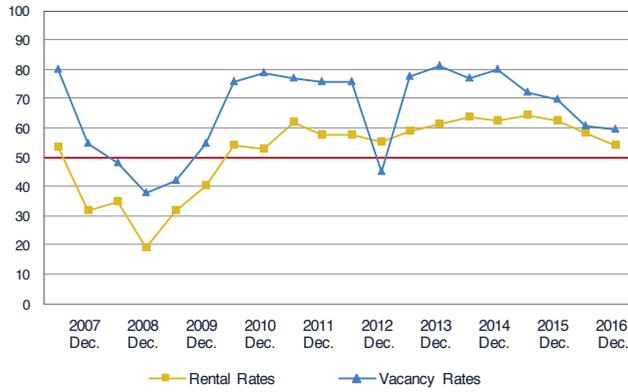
Office markets have been improving ever since. The survey has picked this up with the exception of December 2012, the "fiscal cliff"⁴ and June 2013, when there was a very real threat of an extended government shutdown.⁵ Although the first was avoided and the second was short-lived, they both caused our panels to turn pessimistic, with

Office Space Developer Sentiment for 2019
(>50 optimistic sentiment)

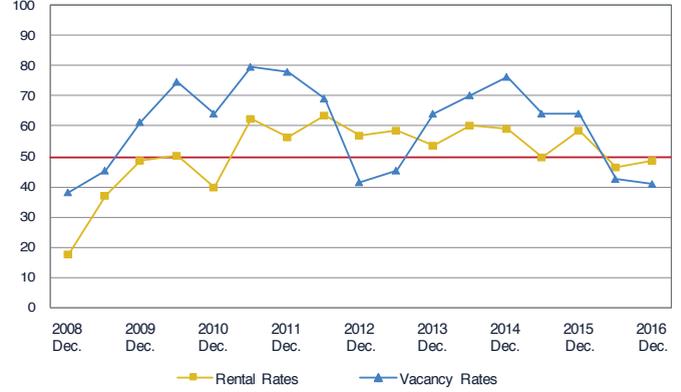


1. See for example Deloitte's analysis <https://www2.deloitte.com/us/en/pages/real-estate/articles/commercial-real-estate-industry-outlook.html>
 2. Jerry Nickelsburg, "Topping Out in California," Allen Matkins UCLA Anderson Commercial Real Estate Survey, July 2016
 3. http://www.nber.org/cycles/recessions_faq.html
 4. See http://www.nytimes.com/2012/11/16/us/politics/the-fiscal-cliff-explained.html?_r=0 for a discussion of the "fiscal cliff."
 5. See <http://www.nytimes.com/2013/10/01/us/politics/congress-shutdown-debate.html> for a discussion of the government shutdown of 2013.

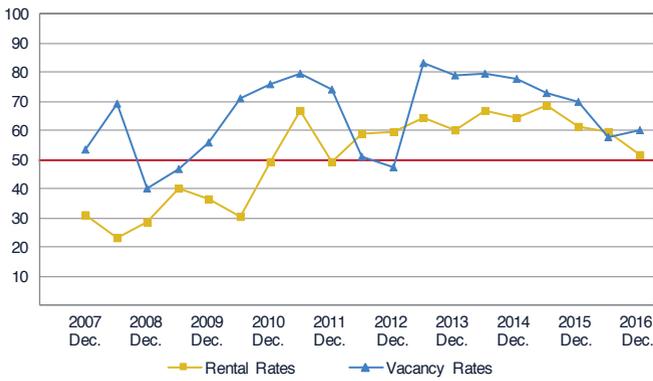
Los Angeles Office Market
Indexes of Survey: 3 year forecast
(>50 optimistic sentiment)



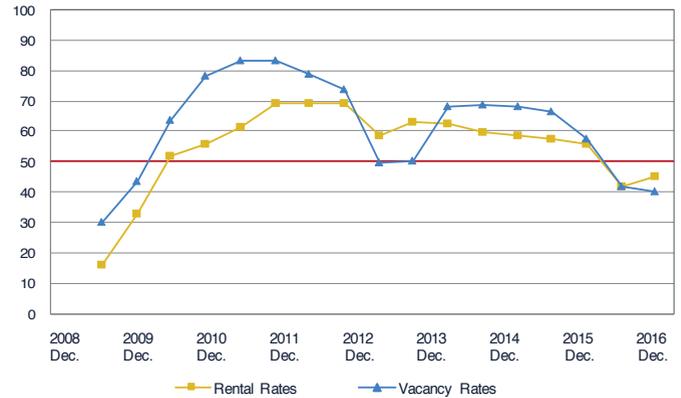
East Bay Office Market
Indexes of Survey: 3 year forecast
(>50 optimistic sentiment)



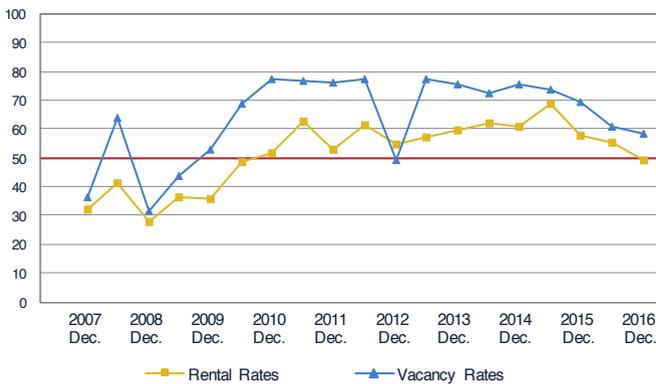
Orange County Office Market
Indexes of Survey: 3 year forecast
(>50 optimistic sentiment)



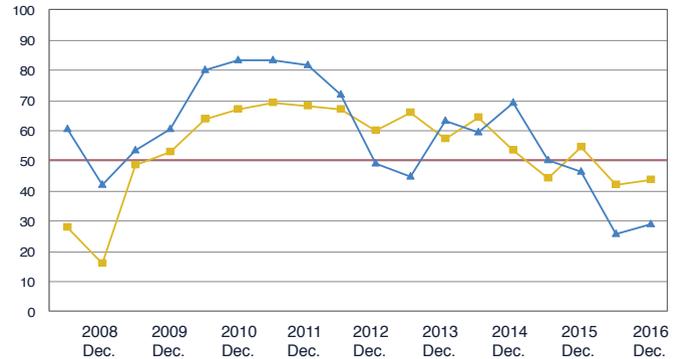
Silicon Valley Office Market
Indexes of Survey: 3 year forecast
(>50 optimistic sentiment)



San Diego Office Market
Indexes of Survey: 3 year forecast
(>50 optimistic sentiment)



San Francisco Office Market
Indexes of Survey: 3 year forecast
(>50 optimistic sentiment)



regard to vacancy rates; a sensible shading of their business plans to a more conservative stance in the face of increased uncertainty. However, overall sentiment, as shown in Chart 1 for 2014 to 2016, remained positive. In fact, the only other time developer sentiment was negative from 2007 to 2016 was in 2007, anticipating the downturn in office space demand associated with the tightening of credit conditions.

The latest survey provides continued evidence of a new topping out of the market for office space. For each of the six markets surveyed, the trend in developer sentiment since the peak in the middle of 2014 has been towards an end to the boom. This occurs as developers become either more pessimistic about real rental rate growth, about vacancy rates or both. In this case it is both. To put this in perspective, pessimistic sentiment does not mean office space is imploding. Rather it says that one ought not expect it to be more robust in 2019 than it is today.

For the Southern California panels, sentiment has slowly diminished and is approaching a level of 50. This level indicates the panel believes markets will be no better, but no worse than today three years hence. Thus, one can say that the panels are still optimistic, but barely so and the trend is towards contraction. In the latest survey 2/3 of the panelists had no plans to initiate a new office project in 2017, and the number will have fallen from the previous two surveys.

In the Bay Area the story is a bit different. The downward trend has moved across the 50 indicator and the San Francisco, Silicon Valley and East Bay panels all think that by 2019 real rental rates and vacancy rates will be worse than today. The downward trend is now decidedly pessimistic relative to current markets. Panelists were most pessimistic about the San Francisco market in spite of Propositions M and C, which limit both new building and the conversion of existing B and C office space in the city.⁶ With respect to new projects there was a marked drop in activity in the Bay Area with 70% of the panelists on the sidelines for new projects in 2017.

6. <http://sf-planning.org/office-development-annual-limitation-program>



COMMERCIAL MARKETS DEVELOPER SENTIMENT

>50 INDICATES POSITIVE OUTLOOK

Arrow denotes change from last survey



Office



Multi-Family



Industrial



Retail

Los Angeles



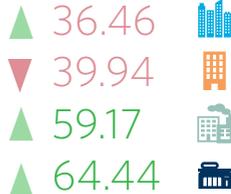
East Bay



Inland Empire



San Francisco



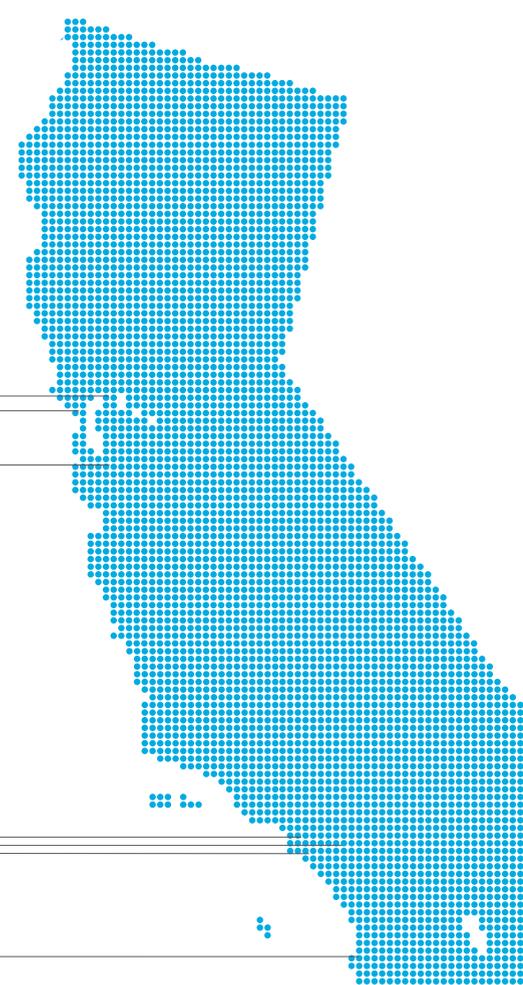
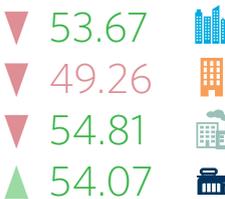
Orange County



Silicon Valley



San Diego



* Index weights have been updated

“You might have more vacancy, but the rates aren’t going to go down because the people with large amounts of product will sit on it until they get their rate.”

- Tony Natsis,
Real Estate Department
Chair, Allen Matkins

“The general tide that lifted so many boats from 2011-2014, that tide is starting to recede.”

- John Tipton,
Real Estate Attorney,
Allen Matkins

“You show me an area where there’s an influx of talent and I’ll show you a healthier office market. It’s all about talent.”

- Lew Horne,
President,
SoCal & Hawaii, CBRE

“Where you have some B-class buildings close to population centers, we’re finding that space becoming very desirable for just-in-time warehouses.”

- Darla Longo,
Vice Chairman,
CBRE



"There's been a little excess of high-end properties and rents have dipped just a bit."

- Kitty Wallace,
Executive Vice President,
Colliers International

MULTI-FAMILY MARKET

TOO MUCH HOUSING?

The real story in the current survey is in apartments. Multi-family developer optimism has remained strong and consistent over the first four years of the survey. The demand for multi-family housing tends to follow job growth in the more densely populated regions of California. Hence, one would expect multi-family housing demand to remain strong and builders to continue to churn out new units. But our survey suggests this market has topped out as well. This is one case where the trends were not there prior to developer sentiment turning down. Could it be a Trumpian effect? One might think so, but that is a stretch.

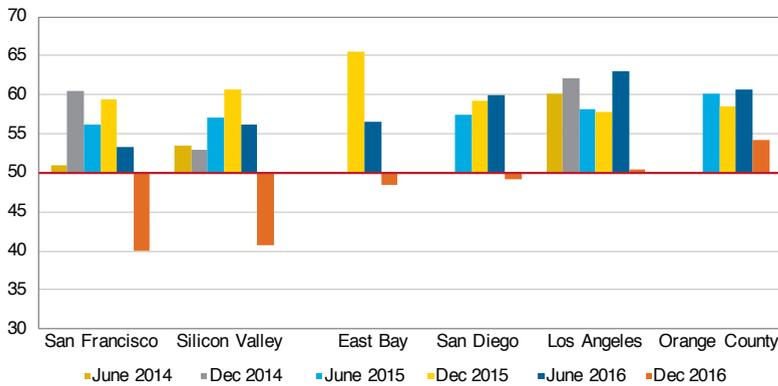
So the first question is; do we have too much housing and the market has topped out due to supply? The answer to that question is both yes and no. California has been generally underbuilding housing and as yet the number of permits for new units barely exceeds 100,000 annually. However, California has been overbuilding high-end multi-family housing. This has occurred both because job growth in tech has generated more high-income earners, and because the cost of land in the coastal cities and the cost of the building process pushes

builders away from low to no margin apartments except in less expensive parts of the State.

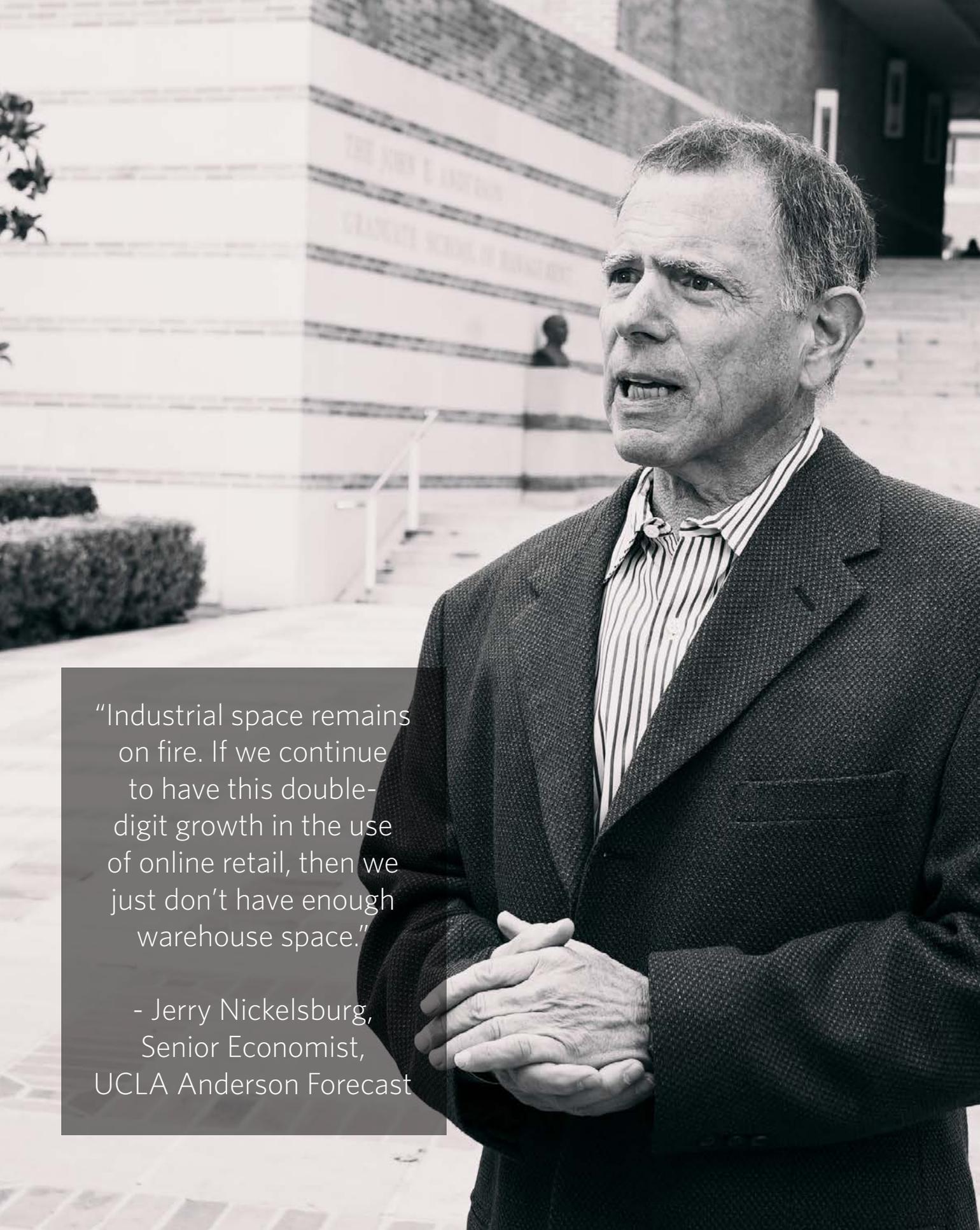
The Anderson Forecast predicts a 20% growth in new housing starts over the next two years, but that would only be sufficient to meet population growth. The California Legislative Analysts Office⁷ concluded that California housing is seriously underbuilt. So rather than a Trumpian effect, our panels' observations are that rents at the high-end have reached their zenith and therefore must decline relative to inflation. Thus, markets in 2019 will not be better than those of today, which does not mean they will be bad, just not as robust.

Faced with this outlook, panelists have sharply curtailed their plans for new multi-family development in the coming year. Fifty-Three percent of the Bay Area panel and 54% of the Southern California panel stated that they would not begin a new multi-family project in 2017. This is up from 39% and 26% one year ago. Perhaps it is the case that the State finally has enough mid-luxury multi-family housing and for the multi-family sector to grow, developers will have to delve into the lower cost apartment market. In their stated plans for the coming year, that segment will wait at least another year.

Multi-Family Housing Developer Sentiment Index For 2019
(>50 optimistic sentiment)



7. "California's High Housing Costs: Causes and Consequences," March 2015. <http://lao.ca.gov>



“Industrial space remains on fire. If we continue to have this double-digit growth in the use of online retail, then we just don’t have enough warehouse space.”

- Jerry Nickelsburg,
Senior Economist,
UCLA Anderson Forecast

INDUSTRIAL MARKET

NO TRADE WARS IN SIGHT

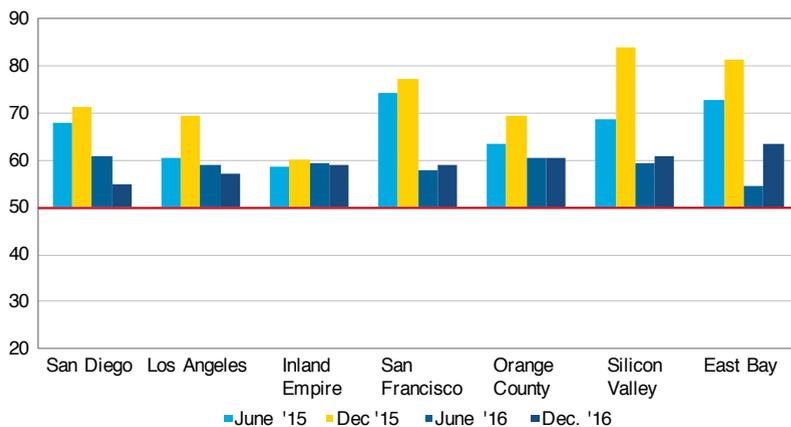
Industrial Space is comprised of two distinct markets: manufacturing and warehousing. Although each geography surveyed has a mixture of both, Silicon Valley, Orange County and San Diego County can be broadly characterized as being more heavily manufacturing, Los Angeles and the East Bay a mix of the two, and San Francisco and the Inland Empire by warehousing. The basic underlying economic forces driving the demand for industrial space in California are manufacturing, the export of goods to Asia and Mexico, U.S. importation of consumer goods from the manufacturing centers of Asia transiting through California's ports, and of increasing importance, e-commerce.

The current Survey of industrial space developers indicates little change in sentiment compared to last year. Industrial markets, particularly the warehouse segment, remain on fire. The latest retail sales numbers are consistent with our panels' views.⁸ This optimism, ex-

pressed in each of the markets surveyed, continues to be manifested in new building. With extremely low vacancy rates at present and an optimistic view by developers the building boom should continue through at least 2019.

The bottom line for industrial space is the shift to e-commerce is happening faster than warehouse space is being built and, trade wars or no trade wars, much more space is needed. In the 2016 holiday shopping season online sales jumped double digits from the previous year. Where once warehouses in the San Pedro Bay to Inland Empire region were an extension of the ports they are now an industry in their own right. If trade wars do not occur, then look for demand for industrial space to be even stronger. In the UCLA Anderson Forecast, the bump in income in late 2017 and early 2018 is forecast to push import growth even faster, which in conjunction with e-commerce will continue the strong demand for warehouses.

Industrial Space Developer Sentiment Index For 2019
(>50 optimistic)



8. <http://fortune.com/2016/09/27/ecommerce-sites-holiday-season/>



“Retail real estate has to go back to basics. Use things that don’t go out of style, like the attributes of what makes a great street.”

- Rhonda Diaz Caldewey,
Managing Director,
Cushman & Wakefield

RETAIL SPACE MARKETS

TAX CUTS?

As of December 2015 the Retail Market Developer Sentiment Survey included all six major California markets. Although there still are very few observations for trend comparisons, some reflections on the data can be made. Part of the difficulty associated with inferences in the retail sector is the fact that retail is undergoing a profound change from distribution conduits to experience-shopping venues.

With the continued strength in industrial space one would expect developers to be very negative about retail. This is because online purchases shift retail demand from brick and mortar distribution to warehouse distribution systems. Yet only in Los Angeles and Orange County are the numbers in the pessimistic zone. The answer for the others regions may lie in recent increases in spending power in the Bay Area, in San Diego, the increases in home construction and more generally a move towards experience-based retail. Nationwide, brick and mortar retail is up. However this is very location specific. Many retailers in old-line outlets nationwide are reporting flat to negative sales numbers for the last holiday season. The expectation of our panelists is that California retail space markets will look much the same.

What is odd about the survey results in December is that about two thirds of the Southern California panelists but only 14% of the Bay Area panelists stated that they were planning new retail construction in the coming twelve months. But it is only odd in a macro sense. Tax cuts and up-scale shopping in the Bay Area may make developers optimistic overall, but perhaps not so much as to jump in with a new retail project. In Southern California, spending power has come to up-scale consumers a little later and the refurbishment of somewhat tired malls is now attractive. Moreover, though the general mood in Southern California retail development is negative, the large new

home building in the southern part of the Inland Empire and in North County San Diego carries with it a demand for new retail space.

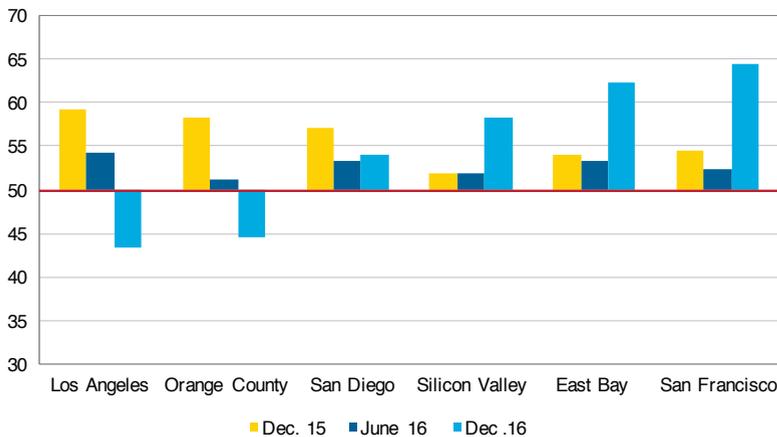
Though the retail survey is quite new and trends are yet to materialize, if e-commerce continues to rapidly gain market share we expect future surveys to reflect a declining sentiment for new retail space. But for now, the survey provides seemingly conflicting data and is not too informative.

Uncertain Policy and Certainty About California?

The Allen Matkins/UCLA Anderson Forecast Survey was designed in 2006 as a vehicle for improving forecasts of the evolution of commercial real estate markets. The current survey provides two interesting observations. The first is a topping out in the natural cycle of office and multi-family development. While markets for these two types of commercial real estate will remain good, they are not so good as to push for an increased amount of development. With respect to industrial space, the survey continues to illustrate the rapid shift in demand and the prospect of even more warehouse construction in the coming three years. And retail, the mixed signals are a signal that the retail space will have very specific sub-market opportunities and risks.

And what about the uncertainty generated by the presidential election? First, the markets are suggesting that the negative economic policies of the new administration may not happen anytime soon and the positive ones might happen right away. Second, there may be greater impact on business and environmental regulation for states other than California. The December survey, taken entirely after the election, seems to say “it doesn’t matter for CRE here.” That could well be because of a forecast of no trade wars and a forecast of California environmental and business regulations being more stringent than the US (and not likely to change anytime soon).

Retail Space Developer Sentiment for 2019
(>50 = optimistic)



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