

NAI CAPITAL

Market Perspective | Fall 2008



Seventh Annual NAI Capital Broker Survey

These are obviously turbulent economic times. At the time of this writing, the capital markets are in crisis, credit is constricted, and the economic outlook is murky. The residential real estate market is still in free-fall and job losses in Southern California have accelerated. While market conditions are still generally healthy in the commercial real estate segments (office, industrial, retail and apartments), there has been a marked softening in the conditions and both sales and leasing activity is down sharply.

In order to provide insight regarding the outlook for the commercial real estate market in Southern California and in Kern County, 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.

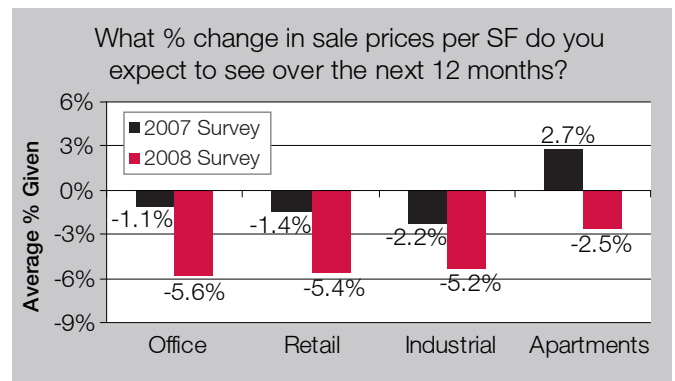
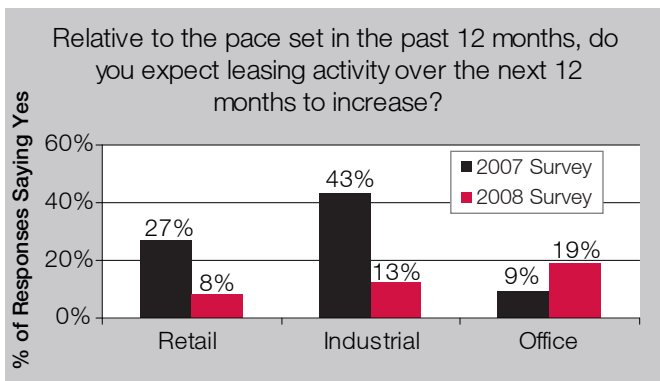
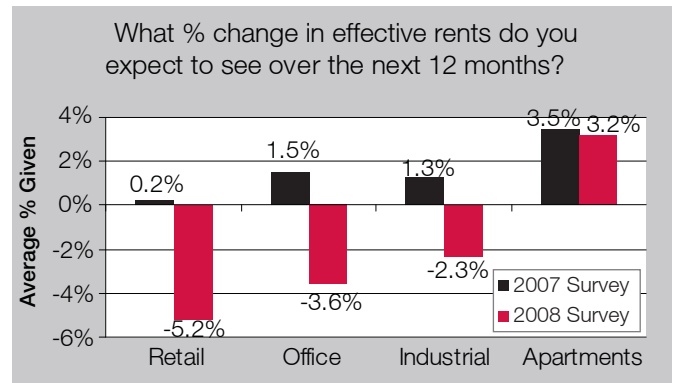
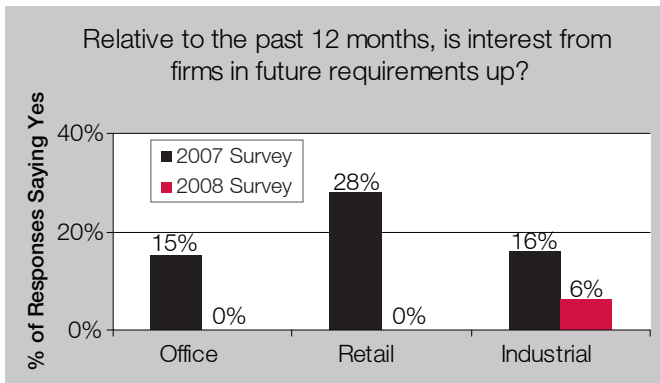
A generally bearish outlook, although some opportunities exist

In the early Fall of 2008 (at the very beginning of the credit crisis), we repeated the survey, and present our findings to you in this report. The major findings from this survey include:

- Most NAI brokers expect **office** market conditions to continue to soften into 2009 and effective rents to continue to drop (by 3.6%, on average). Interest in future

requirements is down significantly, particularly from firms in finance and in real-estate. On the upside, construction starts are expected to drop significantly, enabling the market to tighten starting in approximately a year and a half. Also, significant investment opportunities are seen for those with cash.

- The **industrial** market is also projected to soften, although starting from much tighter current market conditions, particularly in inlying areas. As with office, interest from firms in future requirements is down significantly. Construction activity is also down significantly, which will enable the industrial market to tighten starting in approximately 12 months. In the meantime, rents are projected to drop by approximately 2.3% and sale prices per SF by approximately 5.2%, on average.
- Similar conclusions were made about the **retail** market. Demand for space is down particularly strongly from furniture, coffee houses and fashion, but remains moderately strong from restaurants (particularly fast food). On average, rents are expected to drop by approximately 5.2% and sale prices by approximately 5.4%.
- The **apartment** market has softened some in recent quarters, but still remains generally healthy. The outlook is for general stability, despite the economic downturn, due to consumer sentiment which currently favors renting over owning at this point in time and due to only moderate construction activity (in most areas). On average, rents are projected to climb by approximately 3.2% over the next 12 months, but prices per SF to fall by 2.5%, due to the sharp tightening in lending criteria that is taking place. Buildings in Class A locations and/or with major cash flow are viewed as faring the best.



Detailed Findings

Office

Vacancy rates in the Los Angeles Basin office market bottomed in late 2006 (at 9%) and have since climbed upward (to 12.6%) due to the combination of moderate construction completions (4.3 million SF in the past 12 months, increasing the base by 1.2%) and significant negative net absorption (-5.8 million SF in the past 12 months, for shrinkage in occupied space of 1.8%). Rental rates, which had been growing through year-end 2007, have since dropped (by 2.1% on average).

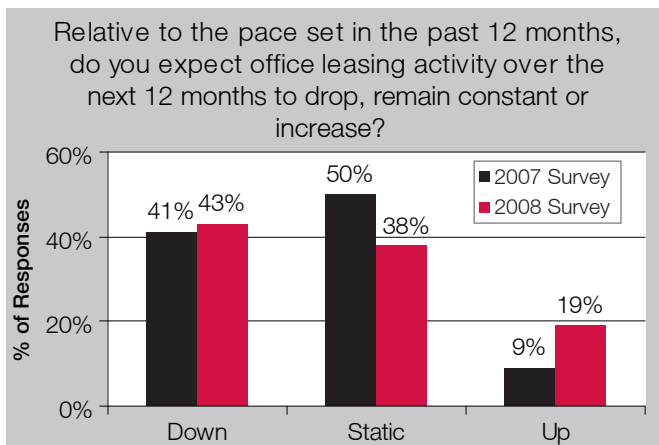
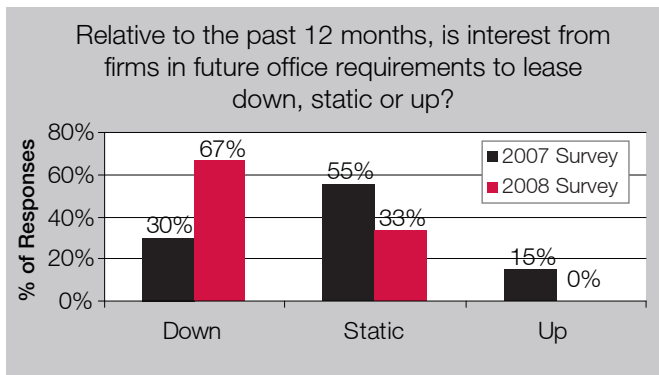
The Fall 2008 Survey shows that most NAI office brokers expect market conditions to continue to soften into 2009 and effective rents to continue to fall.

Two-thirds of those surveyed said that interest in future requirements is down, and none said that interest was up. This is significantly lower than the survey conducted last year, when the majority said interest was at least static.

Interest in future office requirements from firms in finance and real-estate is particularly down. However, moderate interest continues from firms in entertainment, professional services (particularly law and medicine, as well as insurance), and technology.

Interest in future requirements is down significantly

43% of the brokers surveyed expect that leasing activity over the next 12 months will drop and 38% expect that it will be static (at a relatively low pace). This pattern is



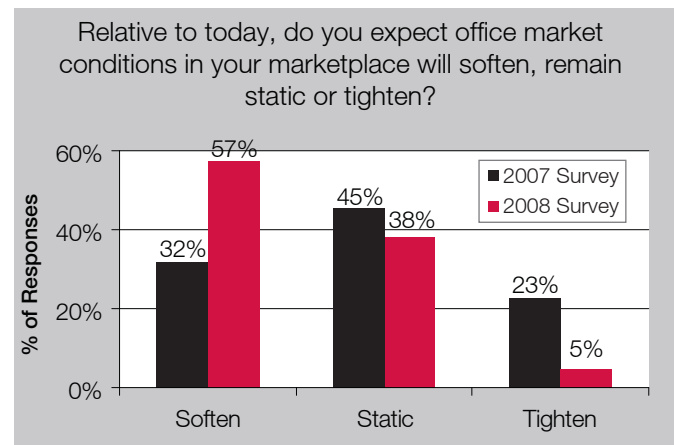
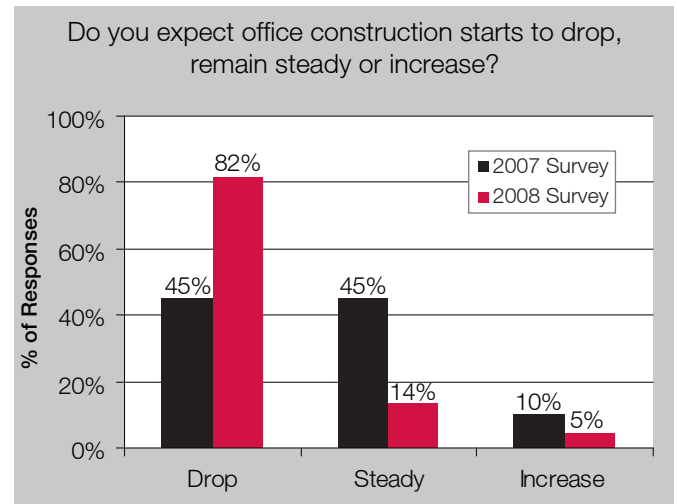
significantly less upbeat than that recorded 12 and 24 months ago. One of the reasons given for the expected slowing is the downturn in the economy, particularly among real estate and finance firms, amplified by the credit crisis.

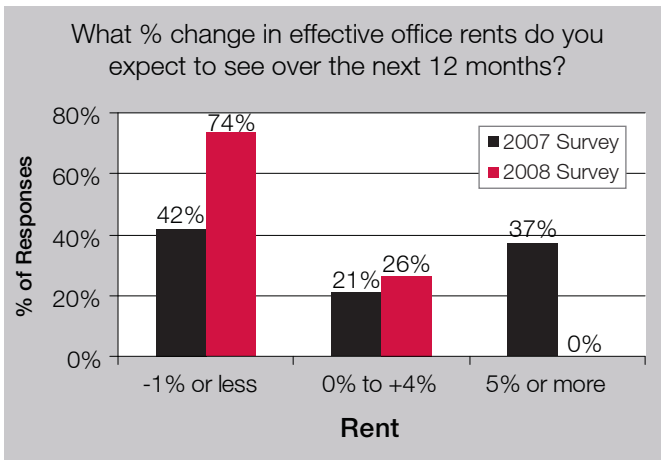
Construction is currently moderate, with 4.4 million SF underway. When complete, the new space will expand the existing base by 1.2%, representing less than a year's worth of supply under normal economic conditions, but more than that in the current soft economy. 82% of those surveyed expect construction starts to drop, due to the combination of weakening market conditions as well as a sharp tightening in construction-lending requirements. This will enable the market to tighten starting in approximately a year and a half (it will take that long for projects in the current construction pipeline to come on-line and for the economy to start growing once again).

In the meantime, 57% of the brokers surveyed expect market conditions to continue to soften. Only 5% expect a tightening.

The majority (74%) expect effective rents to continue to fall, and a minority (26%) expect relatively modest growth (0% to 4%). None expect strong growth in effective rents. The average rent change projected for the next 12 months was -3.6%. Tenant concessions were expected to increase.

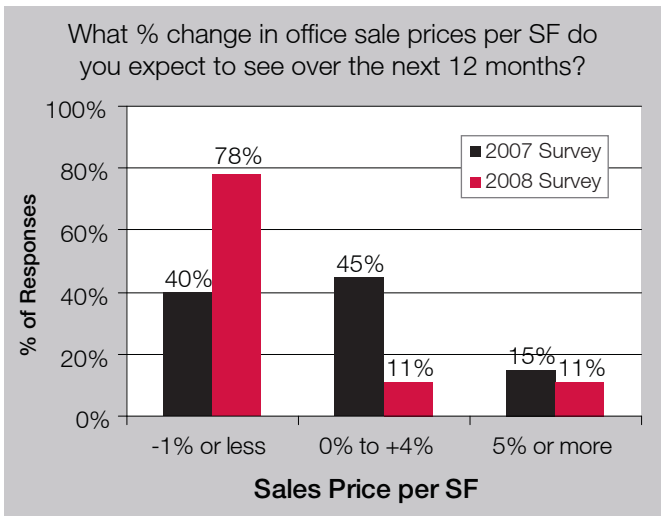
Sale prices per square foot, which continued to climb in most areas through mid-year 2008, are expected to drop in the next 12 months (average projection = -5.6%). 78% of those surveyed predict a decline in value.



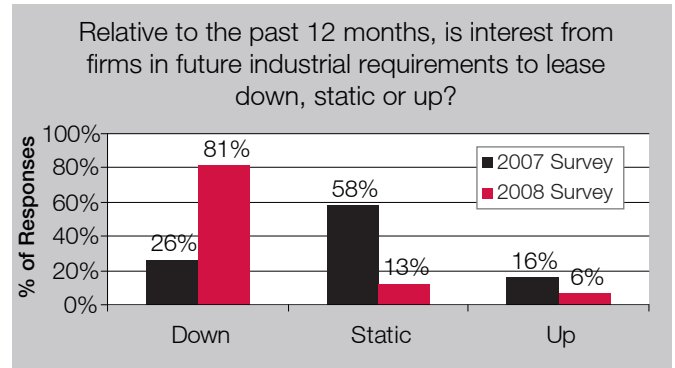


Current interest in future requirements significantly down

Half of the brokers surveyed expect that leasing activity in the next 12 months will be roughly the same as in the past 12 months, but 38% see a decrease. The main reason for the expected flat to slowing leasing activity is the downturn in the economy, particularly among home-building and financial sectors. Interest remains the strongest from logistics firms and distributors (particularly for very large facilities), but weakest from manufacturers. A number of brokers pointed out that time-on-market was up and climbing.

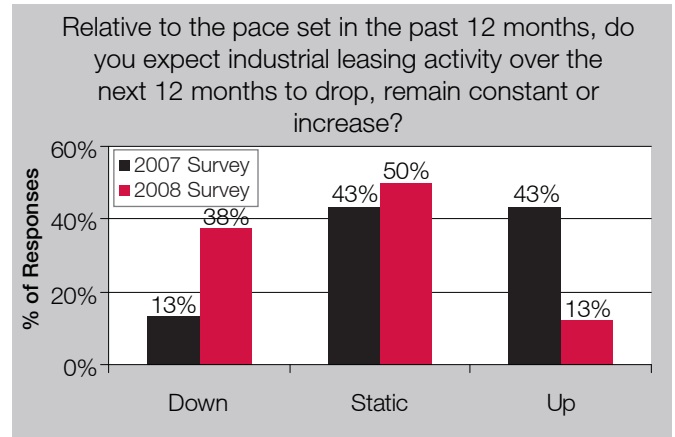


Construction activity has dropped significantly. Currently, 13.2 million SF of industrial space is underway, less than a third of the 31.3 million SF underway a year ago. This is a moderate amount, which will expand the base by approximately 0.8% when completed. The brokers surveyed anticipate that future construction starts will continue to decline, due to the slowing in the economy and the tightening in construction-finance requirements.



Reasons given for the expected decline in value include: sharply tightening credit requirements; softening market conditions; and prices that had climbed significantly in recent years. Tenant risk (the risk of a tenant going out of business) was also viewed as having increased significantly. The greatest opportunities are seen for those with cash, able to take advantage of opportunities offered by any distressed sellers. Green (environmentally friendly) buildings also continued to grow in-favor.

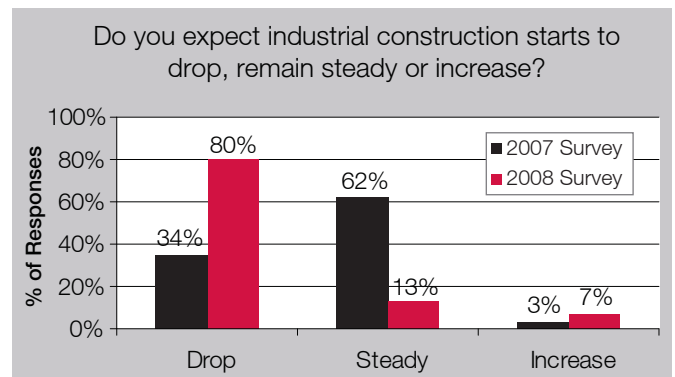
Sale prices per SF expected to drop



Industrial

Vacancy rates in the Los Angeles Basin industrial market bottomed in early 2007 (at 3.3%). They have since climbed some (to 5.1%), but the market is still generally tight-to-healthy, particularly in inlying areas. Rental rates have been relatively flat, following significant increases in 2006 and in early 2007. Sale prices per SF, however, have recently dropped, reflecting the moderate softening in market conditions and a sharp tightening in the credit markets.

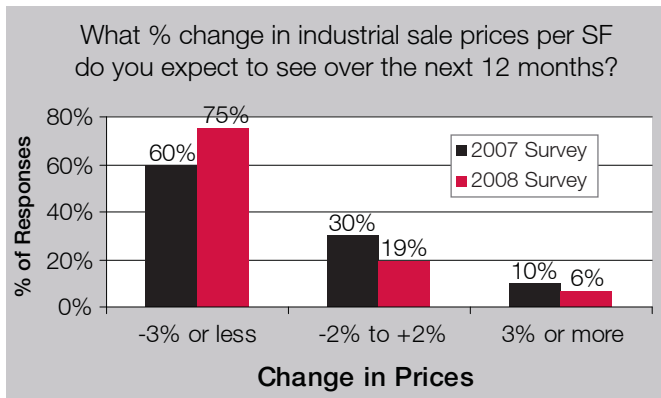
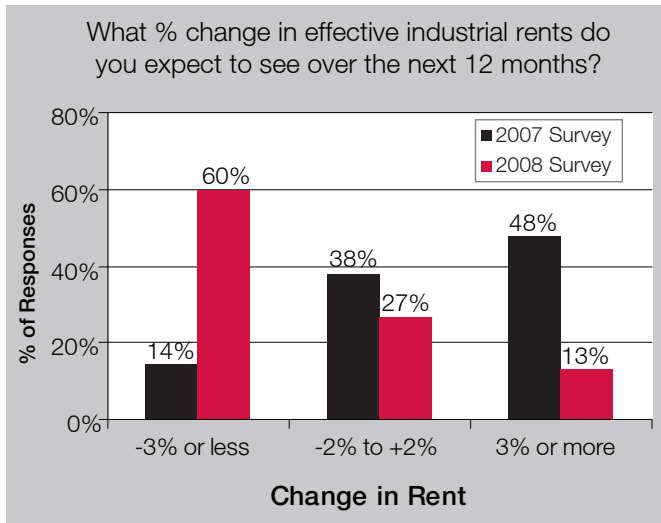
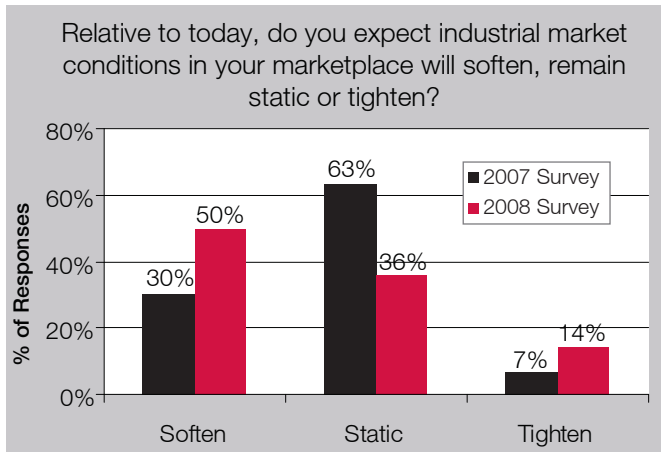
Interest in future industrial leasing requirements is down significantly. 81% report a decline in the number of tenants looking for new space. This is significantly more bearish than the results from the survey taken 12 months ago.



Half expect market conditions to soften over the next 12 months, due to the completion of the 13.2 million SF currently underway as well as the downturn in demand that is taking place. However, market conditions are still expected to remain in generally healthy territory in Los Angeles and Orange Counties and in the West Inland Empire. Conditions are expected to be soft, however, in the East Inland Empire.

Market conditions projected to continue to soften in coming months

As a result of the anticipated moderate softening in market conditions, effective rents are expected to drop over the next 12 months (by -2.3% on average). The majority project relatively significant declines (-3% to -10%).



Demand to buy industrial buildings is expected to drop due to the sharp tightening in lending requirements, the downturn in the economy, and buyer reaction to very high asking prices. Prices are projected to drop by 5.2%, on average. The outlook on prices is significantly more bearish than it was 12 and 24 months ago.

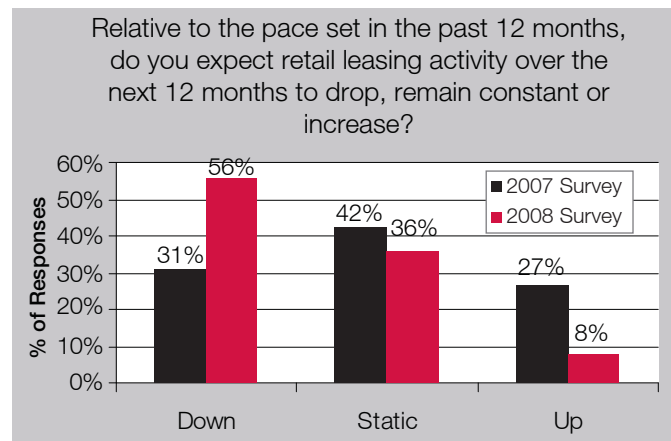
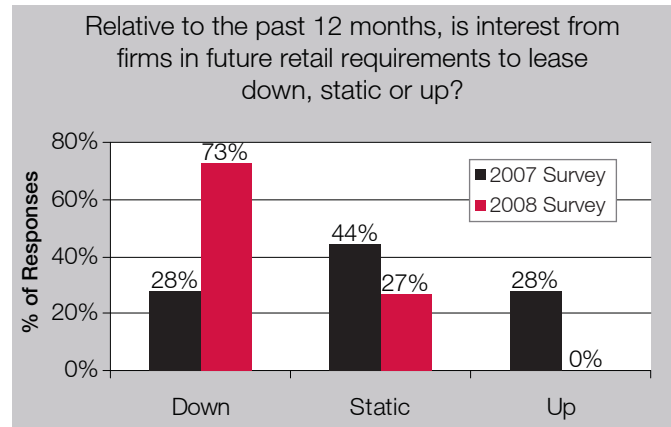
Risks cited by the brokers include high prices and low cap rates. Financing difficulties have escalated, and time to complete deals has increased significantly. As with office, the greatest opportunities are seen for cash-flush buyers being able to take advantage of any distressed sellers.

Prices expected to correct moderately

Retail

Demand for retail space in the L.A. Basin retail market had been very strong through approximately Spring 2008. However, demand has recently slowed due to the downturn in the economy and the credit crisis. Construction activity has remained relatively high, and vacancy rates have crept upward. Vacancy rates are currently in the low 4% range basinwide (3% range in inlying areas, 5%-6% range in outlying areas), up from the low 3% range basinwide a year ago. Effective rents peaked in early 2008, and have since dropped slightly. Prices per SF have flattened.

Most of the brokers surveyed indicate that current interest in future requirements is down. This is significantly more bearish than the survey taken a year ago. Demand is particularly weak from furniture, coffee houses, and fashion, but remains moderately strong from restaurants (including fast food).



A similar pattern is seen regarding future leasing activity. Somewhat more than half (56%) of the respondents expect that leasing activity over the next 12 months will drop, followed by 36% who see activity as static. Relatively few (just 8%) anticipate an increase.

Construction activity has slowed, but is still significant. 11 million SF is currently underway which, when complete, will expand the base by 1.8%. Most of the brokers surveyed (65%) believe that activity will continue to slow over the next 12 months. None believe it will increase.

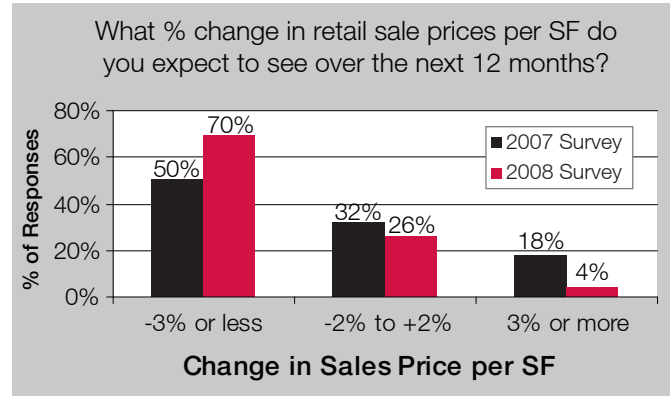
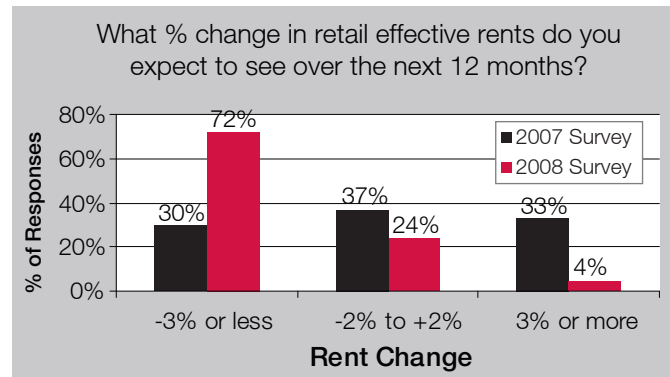
Construction activity expected to slow

The retail brokers are split 37% / 44% whether the market will soften or remain static, and only 19% believe it will tighten. Reasons cited for a possible softening include the downturn in the economy, the tightening of credit, consolidations, a cooling off period from the superheated demand and rent growth of recent years, and the amount of space currently under-construction.

Rents are generally expected to drop over the next 12 months (by -5.2% on average), following the very strong growth in recent years.

Sale prices per SF are also expected to drop (by -5.4% on average). Reasons given for the bearish outlook include: the magnitude of the increase in prices in recent years; the sharp tightening in lending criteria; and a general slowing in investor demand. Tenant risk (the risk of a tenant going out of business) was also viewed as having increased very significantly. Opportunities were seen for those with capital, as well as those who tap into various under-served ethnic areas.

Moderate correction in prices expected



Apartments

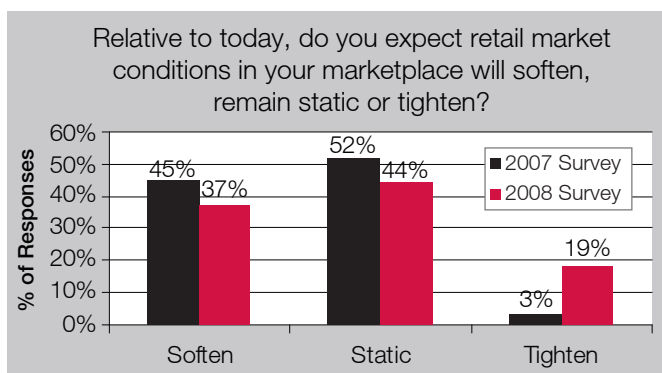
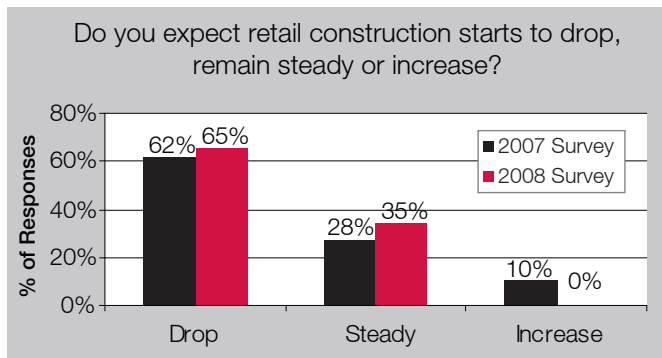
The Los Angeles Basin apartment market has softened some in recent quarters, but still remains healthy, with vacancies in inlying areas in the low-4% range and in outlying areas in the 6% range. Effective rents have grown by approximately 4% to 4.5% in the past 12 months. Construction remains restrained in most of the basin (the exception is a temporary increase in activity in Orange County), and market conditions are expected to remain generally healthy. Investor interest, however, has slipped some, due to the credit crunch and prices that are perceived as being high.

Most (80%) of the brokers surveyed expect market conditions to remain static (at current generally healthy levels). However, some (20%) anticipate a softening, and none a tightening. Positive factors listed as keeping the market afloat despite the economic downturn include: consumer sentiment which currently favors renting over owning; and only moderate construction activity (in most areas). Those anticipating a softening emphasize the impact that the economic downturn may have on apartment demand (potentially causing renters to double-up or to seek lower-rent units).

Most expect market to remain in healthy territory

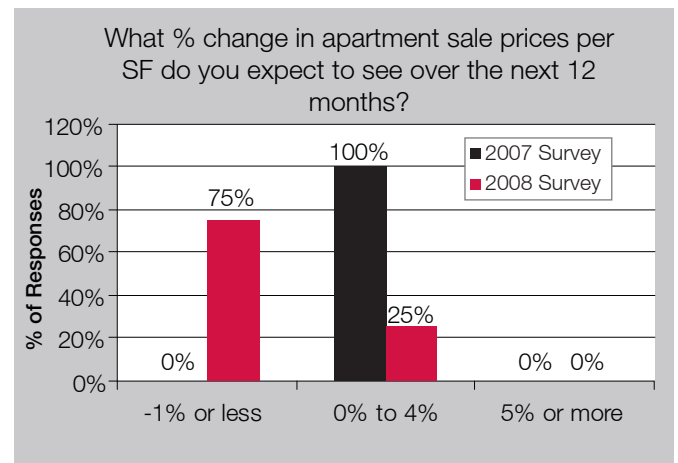
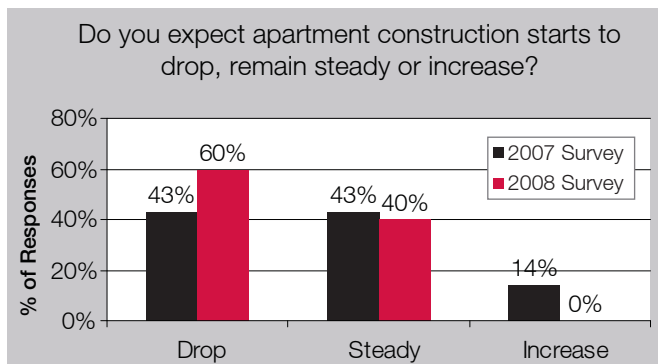
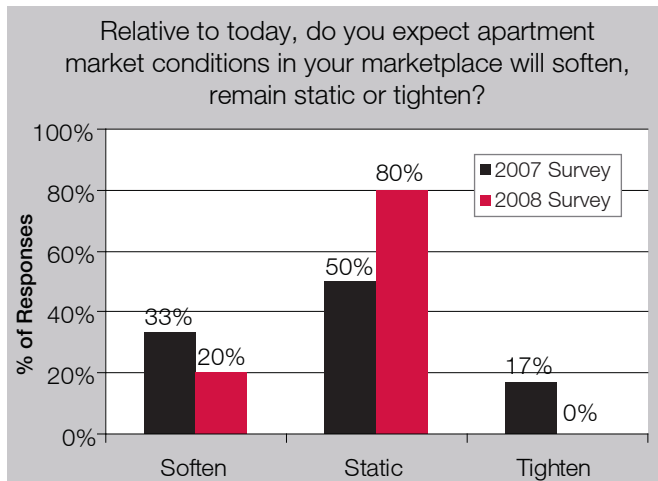
Most expect construction activity to slow, due to the sharp tightening in construction financing. This should help the market maintain healthy market conditions even if demand for apartments by tenants should drop due to the economic downturn. Rent-growth is projected to slow (to 3.2%, on average).

Sale prices per SF are expected to drop some (by -2.5% on average). This projected decline is due to prices that are already



high and cap rates that are already low, as well as the sharp tightening in lending criteria. Buildings in Class A locations and/or with major cash flow are viewed as faring the best.

Moderate rent-growth projected



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