

Our Past Reflects Our Future

The old saying is true. History does repeat itself. A decade ago, for the very first issue of *Real Estate Southern California* magazine, a dozen commercial real estate leaders assessed the market's outlook. While they were generally optimistic, concerns ranged from questions about the capacity of the region's infrastructure to accommodate a booming population to a skittish stock market and uncertain interest rates. Sound familiar?

Much of what was happening when that premiere issue of *RESoCal* rolled off the presses in October 1999 was the result of conditions in the previous cycle: The Japanese, for example, were selling off their Southern California holdings after paying sky-high prices in an unprecedented run-up of values. Similarly, what's happening today is a direct result of a recently ended hot-to-the-touch cycle.

For its 10th anniversary issue, *RESoCal* asked another group of industry leaders for their views on what regional and national market forces, trends or deals shaped commercial real estate in the

Southland over the past 10 years and what their prognosis is for the future.

As those leaders outlined, the forces that shaped our business over the past decade ranged from national and industry-wide trends, like cheap and plentiful capital, to local factors like abundant land in the Inland Empire that enabled that region to mount one of the decade's biggest housing booms.

Without doubt, the driving factor in the industry's run-up was the tremendous flood of capital that washed over the market, along with rock-bottom interest rates that made that capital as cheap as it was plentiful. Each sector, of course, has its own dynamics and the run-up—and subsequent fizzle—for each is colored by those dynamics. Here's what the experts told us:

INDUSTRIAL REFLECT THE TRENDS

One sector that has benefited from these trends is industrial. At least one of the forces driving the local demand for industrial space was international: China emerged as a manufacturing behemoth, churning out mountains of consumer goods that flowed through the ports of Los Angeles and Long Beach to Ameri-

SOCAL's 10-YEAR HIGHLIGHTS

Industry leaders look back at the forces that shaped the market and—more important—what it all means going forward.

can consumers. A local force was the growth of Southern California's ports into some of the busiest in the world, driving a logistics and distribution industry that in turn drove the construction of tens of millions of square feet of warehouses in the Inland Empire. Lance Ryan, vice president of marketing and leasing at Carson-based Watson Land Co., points out that SoCal's industrial inventory has evolved from about 75% manufacturing and 25% distribution 20 years ago to 25% and 75%, respectively, today.

One example of how the events of the past 10 years are driving the future can be seen in deals like one described by Michael Frankel, CFO and partner at Los Angeles-based Rexford Industrial. The price for the completed industrial condo project, with units ranging from 3,500 square feet to 6,500 square feet, is just above \$50 per square foot. This compares with the \$145-plus per square foot that the developer spent on it. "The prices are about the same as the developers were ascribing to land value 18 to 24 months ago," Frankel says.

Deals like this are commonplace,

according to Brian Malliet, managing partner and chief operating officer of Voit Real Estate Services in Newport Beach. Malliet can rattle off a half dozen industrial properties that could be bought today at deep discounts on value. Thanks to the availability of so much property at prices well below replacement, "You're going to see very little development for a couple of years," Malliet says. He points out that Voit has now switched its emphasis from development to asset services, with its portfolio managers taking on property management, construction management and other duties. Two new high-level hires in its asset services group proves the point.

The hiatus in industrial development that Frankel and Malliet describe ranges across all property sectors. At Legacy Residential Partners in Irvine, partner and senior managing director Tim O'Brien observes, "the fundamentals today certainly don't support any type of development." Legacy's strategy "is changing to an acquisition platform" after the company wraps up some \$400 million worth of development that is currently under

1999
The \$400 million Staples Center opens. The sports, entertainment and convention venue becomes a linchpin for a Downtown LA revival and redevelopment.

2000
One of the state's largest health-care companies, HealthNet, signs a \$100-million lease at LNR Warner Center in Woodland Hills that is believed to be the largest signed in Los Angeles County this year at the time of the signing.
http://www.globest.com/resocal/0910_09/10year/1.html

2001
The same J.P. Morgan Chase-advised investment group that already owns the 660,000-square-foot Water Garden development in Santa Monica pays about \$240 million for the adjacent, 600,000-square-foot Water Garden II office complex.
http://www.globest.com/resocal/0910_09/10year/2.html



2002
Wells Real Estate Investment Trust acquires the Nestle USA Inc. US headquarters building at 800 N. Brand Blvd. in Glendale for \$157 million, setting a new record for price per sf paid for a Glendale office tower.
http://www.globest.com/resocal/0910_09/10year/3.html

2003
Investors led by LA-based Thomas Properties Group acquire the 2.7 million-square-foot Arco Towers in downtown Los Angeles for approximately \$270 million, later renaming the complex City National Plaza.
http://www.globest.com/resocal/0910_09/10year/4.html



SOCAL's 10-YEAR HIGHLIGHTS

(continued)

2003

Los Angeles-based CB Richard Ellis Inc. acquires Insignia Financial Group for \$431 million, creating the world's largest commercial real estate services company.

http://www.globest.com/resocal/0910_09/10year/5.html



2005

Maguire Properties pays \$1.5 billion for 10 properties totaling five million square feet in Southern California, Colorado, Texas and Arizona that it buys from a partnership of CommonWealth Partners LLC, Rockefeller Group International Inc and the California Public Employees Retirement System. The assets are known as the Fifth Street Properties Portfolio and includes Pacific Arts Plaza in Costa Mesa.

http://www.globest.com/resocal/0910_09/10year/6.html



2006

GE Real Estate closes on its \$5 billion acquisition of Arden Realty, a publicly traded office REIT based in Los Angeles and founded by Richard Ziman that goes private with the GE acquisition.

http://www.globest.com/resocal/0910_09/10year/7.html



2007

NNN Realty Advisors, the parent company of Santa Ana-based Triple Net Properties, the tenant-in-common industry pioneer founded by Tony Thomson, merges with Grubb & Ellis Co. to form a new G&E with a market capitalization of \$725 million.

http://www.globest.com/resocal/0910_09/10year/8.html



construction. "It's becoming a good time to buy again."

MULTIFAMILY'S BEST DECADE AHEAD

The former flood of capital also flowed into high-rise multifamily development in Los Angeles and Orange counties. "There was no high-rise housing in Orange County and very little in LA 10 years ago, except for a few buildings along the Wilshire Corridor," O'Brien points out. He says that the proliferation of such projects "was driven not out of need or desire but by developers looking for the next opportunity." He estimates that some 40 high-rise proposals are on the books in Orange County alone, but how many will get built is another question entirely.

"High-rise housing is not going away," O'Brien says. "It's just not going to be

driven by financing opportunities; it's going to be built at locations that make sense." He believes that the outlook for multifamily housing in Southern California overall is nevertheless bright, and he cites the growing demand from Echo Boomers and seniors. The next decade, he says, will be one of the best for multifamily housing in general, and for apartments in particular.

Among those who are counting on the region's continuing multifamily demand is Irvine-based Sycamore Urban Properties, which is focusing on acquiring partially and fully completed distressed condominium and apartment-to-condo conversion projects. According to Mitchell Bradford, president of Sycamore, the company is buying projects that it can operate at market rents until the economy im-

Brokers Retrench as New Cycle Begins

One of the industrywide trends in the past decade has been the consolidation of service firms. One question as we get set for a new cycle is how it will affect the service side of the business. Harvey Green, Encino-based president and CEO of Marcus & Millichap Real Estate Investment Services Inc., says that the most likely answer is that "in the next couple of years, you are going to see fewer practitioners than you have in the past, and a smaller number of firms."

Sperry Van Ness International president Kevin Maggiasco agrees that such a winnowing is likely. He points out that in previous downturns, service-firm market shares have shifted significantly, scores of agents have left the industry and long-established companies have gone out of business.

One result of the most recent cycle, according to Green, is that "there was so much velocity that you really didn't need deal-making skills. You just had to be a conduit to the inventory and you could make money. That's not what professional commercial real estate practitioners are about."

Jim Kruse, Beverly Hills-based senior managing director of the LA South Region for CB Richard Ellis Inc, estimates that "probably the bottom 20% of the brokers in the industry" are going to leave. "If they were not making a very good living during the great times, they are making no living now." He says CBRE "gets calls every day from people who are on a flight to quality to a stable firm that can support their business."

And despite the doldrums plaguing the brokerage business right now, Marcus & Millichap's Green says, the industry's prospects are good in Southern California. "Every time the market is hot, it seems like it will never end, and every time it is down, it seems like it will never get back again," he observes. "It's another cycle. The economy will come back, and so will the real estate business."

proves enough that the for-sale market returns and the firm can sell the units. Sycamore's target price three or four years from now could be approximately \$300,000 or \$400,000 per unit, "and

from now, if competitors are going to start from the ground up, they will have a basis of cost that could be 50% more than ours." Like many others in the industry, Bradford adds, Sycamore knows

organizations in Southern California are adjusting to the conditions wrought by the end of commercial real estate's latest boom. Burrel Magnusson, CEO of Essex Realty Management and founder of the Irvine-based Essex Group of Cos., says his experience as a developer and investor in previous downturns led him to the service side of the business. "I acquired Essex in the early 1990s, partly in response to the downturn back then," he recalls. "I decided that it might be a good idea for a developer to get into the service business as a complement to the transaction side and somewhat insulate yourself from times like this."



"There was no high-rise housing in Orange County and very little in LA 10 years ago, except for a few buildings along the Wilshire Corridor."

TIM O'BRIEN
Legacy Residential Partners

there won't be that much housing available at those prices then," Bradford predicts. Pointing out that his firm is buying properties below replacement value, he says, "Three or four years

that development will occur again. "It's just a question of how much there will be and at what expense."

Strategies like those of Sycamore, Voit and Legacy illustrate how individuals and

Such changes of direction by individuals and organizations occur with each new cycle in commercial real estate. Dave Doupé, a West Los Angeles-based international director in the capital mar-

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SOCAL'S 10-YEAR HIGHLIGHTS

(continued)

2007

Maguire Properties of Los Angeles buys a 41-property, 8.5-million-square-foot portfolio of former Equity Office Properties buildings for \$2.88 billion, including the trophy 621,000-square-foot 550 S. Hope building in Downtown LA.

http://www.globest.com/resocal/0910_09/10year/9.html



2007

Cabi Developers, the local arm of Mexico's Gicsa, buys a 33-property office portfolio totaling 4.6 million square feet from Los Angeles-based Arden Realty for \$1.5 billion, including the 243,000-square-foot Century Park Center at 9911 W. Pico Blvd.

http://www.globest.com/resocal/0910_09/10year/10.html



2008

Houston-based Hines acquires nearly 4.5 million square feet of space with the acquisition of 31 office properties comprising more than 50 buildings from Cabi Developers, the US arm of Mexico's Gicsa, in a deal valued at nearly \$1.4 billion, including the 243,000-square-foot Century Park Center at 9911 W. Pico Blvd. This is most of the same portfolio that Cabi bought from Arden in 2007.

http://www.globest.com/resocal/0910_09/10year/11.html

2008

Douglas Emmett Inc. of Santa Monica buys 1.4 million square feet of office in six class A buildings in West Los Angeles and the San Fernando Valley from West LA-based Arden Realty Inc. for \$610 million, including 9100 Wilshire Blvd.

http://www.globest.com/resocal/0910_09/10year/12.html



Timeline Source: CB Richard Ellis Research

kets group of Jones Lang LaSalle Inc., says that before the downturn JLL's capital markets group focused more on the traditional institutional owners of real estate, like REITs and major investment management firms. Now, he says, "We spend about a tenth of the amount of time with those groups than we did three years ago. Now it's all about the banks." The shift in focus mirrors similar shifts in previous downturns. "In general terms, the focus that we have now is the same as in 1983 and 1984, working with banks that were foreclosing on real estate, and in the mid-1990s, when we were focusing on lenders and government agencies," Doupe says.



"You're going to see very little development for a couple of years."

BRIAN MALLIET
Voit Real Estate Services

THE FUTURE OF FINANCING

The nature of the current downturn has put a major emphasis on troubled assets, and how long it will take to work through all of the distress is anyone's guess. "It's hard to predict when we will have a functioning debt market with liquidity at reasonable terms," says Bill Winn, president of Irvine-based Passco, a pioneer of the tenant-in-common industry that burgeoned in the past decade.

Harvey Green, the Encino-based president and CEO of Marcus & Millichap Real Estate Investment Services Inc, observes that the CMBS market "for all intents and purposes is gone for now, so over the next several years, someone will have to create some form of new financing vehicle or capital sources," to fund the recovery when it begins. "That will happen, and it will help our industry."

Like Green, Winn says that it remains to be seen how the CMBS market revives and how large a role banks or other capital sources will play. He agrees that

the next cycle of investing will include a new type of vehicle, the Delaware Statutory Trust, which was just getting started when the last cycle ended. (Winn is also president of the Real Estate Investment Securities Association, which was known as the Tenant-in-Common Association until it changed its name this summer to reflect the group's broader reach.)

Winn points out that "we will have to see some increase in consumer confidence and spending," before any commercial real estate recovery can gain traction. He explains that consumer spending drives the retail engine that, in turn, drives the production of goods moving through the Southland's ports.

When the recovery does begin and investing starts to pick up, industry veterans say it will be different, at least for a while. "Future equity investments and debt will be very much return-driven," says Magnusson of Essex Realty. "Traditionally, returns have been heavily weighted toward income stream and cash flow and less weighted to appreciation. But in this latest bubble we had an almost total reliance on appreciation and very little on the actual income that could be generated from the asset."

BUYING FOR THE LONG TERM

Not all investors, however, relied on quick flips as the bubble grew, and many, like Watson Land, remain the same long-term holders they have always been. "Our perspective is to buy, develop and hold," Watson's Ryan says. He points out that the company thinks in terms of holding properties for decades, not years. The firm, although neither a buyer nor a seller of buildings in the past 10 years,

made a significant move into the Inland Empire, buying development land in Chino, Fontana, the Redlands and Apple Valley. Among its recently completed projects is a 297,107-square-foot LEED Gold-certified Legacy building at Watson

Commerce Center Chino.

One feature of the Legacy buildings is an emphasis on landscaping that conserves water and returns it to the groundwater system rather than dumping it into storm sewers. This emphasis on water conserva-

tion has taken on new significance lately in Southern California and will take on even more in the coming years, according to Dave Hanson, a senior vice president at the ValleyCrest Landscape Maintenance division of Calabasas-based ValleyCrest

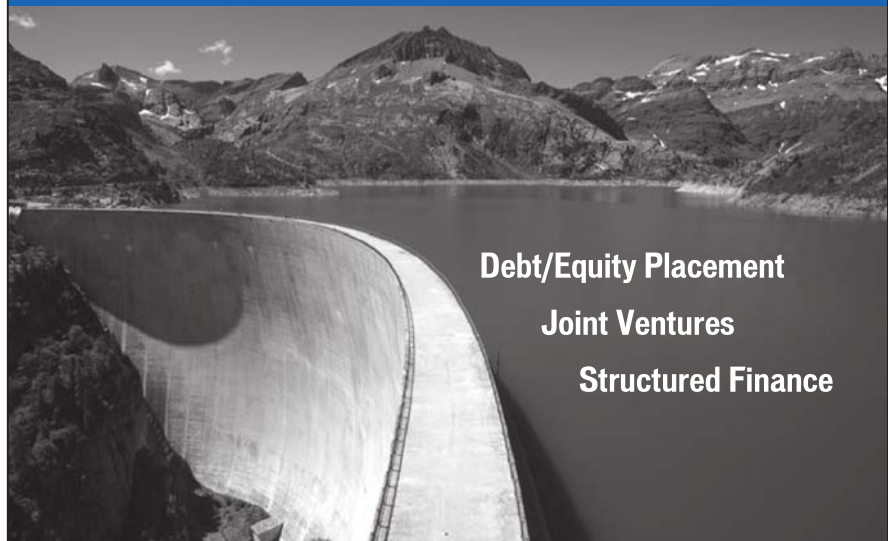
Follow the Bursting Bubbles

Gerald Porter calls them "Bookends" at opposite ends of a decade. The Los Angeles-based chairman of CresaPartners is talking about the dot.com bubble that burst when Internet companies began failing, which was followed by the "Monopoly Game bubble" that popped almost 10 years later as a result of the subprime mortgage meltdown. In the first case, Internet companies gobbled up space so voraciously that office rents soared in places like West Los Angeles, but the rates settled back in the range of \$2 to \$3 per square foot per month when the dot.com bubble burst.

Porter says that the \$2-to-\$3 range is where office rents are heading again after zooming to new heights at the peak of the past cycle, when at least one West LA building was quoting asking rates of \$8 per square foot. That's how much building owners need to charge when they pay \$500 to \$700 per square foot for their properties, Porter explains, but with very few exceptions, "Market rents are going to support building prices of \$200 to \$300 per square foot, not \$500 or \$600."

Rents on the Westside are now running between \$3 and \$4, according to West LA-based EVP and branch manager Mike Catalano of Studley, who says that the rates have already lost most of what they gained. "Vacancy plummeted and rates just got out of control, which has all been corrected," Catalano says. "I'm not saying we're at the bottom, but most of the astronomically high rates that we saw in 2007 are gone."

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Los Angeles Industrial Statistics					
Year	Inventory (sf)	Availability Rate	Total Vacancy (sf)	Total Net Absorption (sf)	Average Asking Lease Rate
1999	900,901,958	5.5%	3.2%	6,438,051	\$0.51
2000	927,959,249	5.4%	3.0%	26,095,941	\$0.53
2001	934,462,495	7.5%	3.7%	3,622,534	\$0.49
2002	946,287,310	6.8%	2.8%	12,899,575	\$0.48
2003	957,418,370	7.0%	2.5%	10,989,055	\$0.51
2004	968,926,613	6.3%	2.2%	13,019,980	\$0.53
2005	979,154,086	5.0%	1.8%	11,018,825	\$0.60
2006	979,694,376	4.7%	1.5%	4,239,841	\$0.65
2007	985,502,294	4.7%	1.6%	-814,511	\$0.69
2008	989,845,310	5.7%	2.5%	-5,080,734	\$0.67
2009 YTD	991,762,620	7.7%	3.2%	-8,130,160	\$0.64

10-Year Track Record

The following charts show how the office and industrial markets have fared in Los Angeles county over the past 10 years. Office rents climbed steadily throughout the decade until their peak in 2007, after which they began to decline. Industrial trends indicate a more gradual decline.

Los Angeles Office Statistics				
Year	Inventory (sf)	Direct Vacancy (sf)	Total Net Absorption (sf)	Average Asking Lease Rate
1999	165,433,027	11.5%	3,990,528	\$1.78
2000	171,677,913	10.4%	6,588,363	\$2.02
2001	177,684,796	11.7%	248,932	\$2.16
2002	182,082,285	14.2%	-945,787	\$2.11
2003	185,631,714	14.2%	703,685	\$2.09
2004	185,050,565	12.9%	3,524,415	\$2.14
2005	186,481,775	10.5%	5,644,640	\$2.26
2006	198,100,448	8.8%	3,148,056	\$2.31
2007	200,668,689	9.0%	1,013,878	\$2.84
2008	203,217,355	11.7%	-2,757,070	\$2.64
2009 YTD	205,279,762	13.9%	-3,921,146	\$2.58

Source: CB Richard Ellis Research



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Landscape Cos. Water, or lack thereof, has already been a contentious issue in proposals for some large Southland projects.

Hanson points out that pressure to conserve water will continue to grow



“The prices that we are looking at are about the same as the developers were ascribing to land value 18 to 24 months ago.”

MICHAEL FRANKEL
Rexford Industrial

in drought-prone Southern California, where prices will increase in the coming years as water becomes an ever-more-precious resource. Hanson notes that AB 1881, a California law that targets mainly new construction and commercial landscapers, will, among other things, establish water budgets that will limit how much each new building can use.

While most developers will be waiting a few years before they think about water budgets or other facets of new construction, the consensus is that it's only a matter of time until development and investment begin anew in the Southland. “We see a rerun of the '90s for SoCal commercial real estate,” says Kevin Maggiacomo, president of Sperry Van Ness International. He foresees a continued erosion of values for a couple of years, followed by gradual stabilization and ultimately recovery. “That being said, the last time around it took about 10 years for property values to return to their 1989-1990 highs,” Maggiacomo says.

His observations underscore a theme that is recurrent with nearly all of the market leaders: The more things change in commercial real estate, the more they stay the same. “We operate in a market-driven cyclical business,” says Malliet of Voit. “Prices will rise and fall, whether it's the availability of cash that causes them to go up, an investor rush from the stock market or some other outside global force that comes along to drive things up and down.”

OFFICE RECOVERY REMAINS A MYSTERY

Green of Marcus & Millichap says that the commercial real estate markets “will come back quickly and strong in

Southern California, which will not be the case in all parts of the country.” He points out that the Los Angeles Basin did not indulge in the overbuilding of office space that marked the previous cycle, when falling demand was combined with a glut of space.

Nonetheless, the recovery as it pertains to the office market remains a big question because that depends in large part on job creation, and even the most positive projections put California's return to its pre-recession em-



“In general terms, the focus that we have now is the same as in 1983 and 1984, working with banks that were foreclosing on real estate.”

DAVE DOUPÉ
Jones Lang LaSalle Inc.

ployment levels at 2013, notes Gerald Porter, the Los Angeles-based chairman of CresaPartners. Porter points out that when he began in the business in 1980, he was doing office deals at \$2 to \$2.25 per square foot, and 10 years later rents had moved only to about \$2.25 to \$2.50. “The needle has hardly moved from that \$2-to-\$3 band in the Greater Los Angeles market for 20 years,” Porter says. Neither has it moved in Downtown Los Angeles. “It's still essentially \$35 rents; \$3 full-service

gross has been the high-water mark for the past 20 years or more.” An essential element of an office recovery in the next decade will require that building owners acquire and operate buildings at costs that can be supported by those rents.

HOTEL FREEFALL

Another question is the recovery of the hotel market, a sector that has been in a freefall. After a decade of new construction and ever-rising lodging prices, the state is on track to post its lowest number of hotel sales in at least 15 years, according to a mid-year look at hotel sales by Irvine-based Atlas Hospitality Group. The number of hotel defaults and foreclosures is rising quickly, and conditions are likely to deteriorate further before they improve, says Atlas president Alan Reay.

Before hotel sales can begin again, “There will have to be a complete repricing throughout the entire market,” Reay says. While he foresees sales stagnating for the rest of this year, the pace of deals should eventually accelerate as lenders place more foreclosed properties on the market at substantially lower

prices in order to clear them from their books, the Atlas president says.

As the past decade began, CB Richard Ellis Inc. senior managing director Jim Kruse recalls, “All of the major holders of real estate were blessed with market forces that were born of the last recession.” Southern California once again faces market forces born of the last recession, so it wouldn't be surprising if, 10 years from now, we are talking about how the bubble burst in Southern California real estate and when it will start building again.”—SOCAL