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MARKET HIGHLIGHTS, SEPTEMBER 2012

ORANGE COUNTY

By Kevin Turner, Matt Didier, Joe Leon and Mathew Mousavi

Orange County is still one of the West's most desirable submarkets, and its high barriers to entry are only driving up demand — and price. The multifamily market is doing very well, especially among Millenials, and retailers are snatching up spaces just as quickly as they become available.

INDUSTRIAL

The Orange County industrial market continues to demonstrate its resilience. The market has posted more than 4 million square feet of positive absorption since 2010, and it continues to display positive rent and sale price growth, along with decreasing vacancies. Demand for mid-sized industrial space remains strong, while interest in larger, big-box product is on the rise.

Turner

Industrial consolidation has become a clear trend in Orange County and throughout Southern California. In the past 24 months, more than 100 transactions have closed in Orange County in the 50,000-square-foot-and-above range, which is considered big box inventory in the market. In line with this trend, more than 30 transactions in the 500,000-square-foot-and-above range have closed in the Inland Empire during the same period.

A portion of this demand for large space is the result of an increase in domestic manufacturing and near-shoring, which is a direct correlation to the recent spike in Chinese labor costs. With free trade agreements with Canada and Mexico, as well as the KORUS agreement with South Korea, more home electronics will begin to be manufactured in South Korea and Mexico as companies relocate manufacturing operations.

For example, Visio recently made a significant investment to expand its planned operations in Mexico. As manufacturing moves toward Mexico and Canada, more companies will seek industrial product in Orange County and throughout Southern California.

The core of the Orange County manufacturing market lies in pharmaceutical, medical device and instrumentation. The intellectual talent pool in this market is second to none as it relates to high-tech and manufacturing expertise, as well as process management.

With that in mind, the challenge in Orange County is supply. As a two-tiered market, Orange County industrial product can typically be classified as Class A and "everything else." While Class A product is always in play regardless of market conditions, there is a limited supply of these available spaces.

More than 100 transactions have closed in Orange County in the 50,000-square-foot-and-above range in the past 24 months. This includes a new 5-year lease of an 85,000-square-foot industrial building at 2900 McCabe Way in Irvine that is owned by Crown Associates Realty.

In addition, the availability of land is highly constrained in Orange County. Infill sites only occasionally become available, providing the opportunity for a new building to be developed.

This lack of supply will drive industrial rents and sale prices up in Orange County, provided that the U.S. economy continues its recovery.

The fragility of the economy is still evident, even as market conditions steadily improve. Corporate and mom-and-pop users alike continue to behave conservatively, and uncertainty remains as the country awaits the upcoming election. That said, once accretive job growth is underway, and the GDP growth increases to above 3 percent, Orange County will experience a substantial spike in industrial rents and the market will be able to fully recover.

— Kevin Turner, senior vice president, Voit Real Estate Services' Irvine office

OFFICE

The overall Orange County office market continues to bounce along as a lack of demand from tenants is the main issue hampering an otherwise healthy, yet steady rebound. The office market realized 1.85 million square feet of positive absorption, relative to an 80-million-square-foot inventory in 2011, with most institutional investors bullish on a 2012 recovery. Absorption, however, has slowed dramatically with only 326,000 square feet of positive absorption year to date. Current activity has seen its typical summer slowdown which has been compounded by tenants awaiting election results to better understand government policies moving forward. The majority of larger corporate users in the market are also looking for similar amounts of space, so we are not anticipating significant positive absorption over the next 12 months.

Average asking rents have stabilized countywide over the past 12 months. They currently stand at $1.89 per square foot, which is down from $1.91 from the end of 2011. Effective rental rates are between 10 percent and 15 percent below asking rates depending on the quality of the project, its location and the required capital. We anticipate rents will remain stagnant through the end of the year, and probably through at least the first half of 2013 as well.

The capital markets have seen a rollercoaster ride similar to the office leasing market, as there is capital available and larger office projects on the market. However, there is too often a disconnect on pricing. Several larger trophy assets have traded in the past 12 months but just as many assets failed to meet sellers' expectations and were removed from the market. The Michelson, a 536,000-square-foot, Class A high-rise office in the John Wayne Airport submarket, is currently under contract for a price supposedly approaching $281.4 million, which would be a high-water mark since the height of the market. The Michelson is arguably the best office building in Orange County and boasts a rent roll including Hyundai Capital, Jacobs Engineering, LA Fitness, Bryan Cave and Gibson Dunn.

One of the leading indicators for the office market is job growth, which drives corporate expansion and positive absorption. The unemployment rate in Orange County was 7.9 percent in June 2012, which was up from a revised 7.5 percent the prior month and well below the 9.1 percent estimate a year ago. This compares with an unadjusted unemployment rate of 10.7 percent for California and 8.4 percent nationally during the same period. Between June 2011 and June 2012, total nonfarm employment increased by 31,500 jobs, or 2.3 percent. As is typical of Orange County's diversity, job growth came from several industries, with the drivers being professional and business services, leisure and hospitality, and trade, transportation and utilities. Construction and government are the only two industries to post negative job growth over the past 12 months.

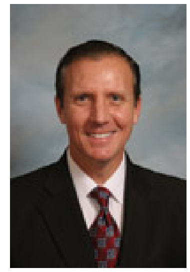
While speculative development has gained momentum in the industrial market given the lack of available functional inventory, the office market has seen little new construction in recent years. The lone project under construction is the 380,000-square-foot, build-to-suit property in Newport Center by Irvine Company. It will soon serve as the new corporate headquarters for PIMCO, one of the world's largest investment management firms.

— Matt Didier, senior vice president, Colliers International's Irvine office

MULTIFAMILY

Orange County remains a strong apartment investment market because of its economic strength, population growth and expensive housing. The county's demographic composition creates strong apartment demand, which makes apartment investors eager to acquire with the expectation of future upside. As of June 2012, unemployment in Orange County has dropped to a 7.9

percent year-over-year improvement of 1.3 percent, compared to 9.2 percent from June 2011. The most aggressive apartment investors are underwriting aggressive assumptions for continued economic improvement, rent growth, new apartment development, and increased apartment demand and hefty rental growth (5 percent to 7 percent).



Leon

As of the end of the second quarter of 2012, investors are actively pursuing Class A apartment properties in the mid- to low 4 percent cap rate range. This is due to the aggressive nature of rental growth in Orange County core markets.

With U.S. Treasury Bills at an all-time low of 1.65 percent, and the continued lending by Fannie and Freddie, attractive multifamily financing has been a large driver for cap rate compression. Attractive rates are also available to single-family homebuyers, but with the difficulty of qualification, uncertain employment levels and minimal wage increases, home loans remain difficult to obtain.

In the midst of recent aggressive acquisitions, investors are looking for justification for the very low trade cap rates. Orange County is a major metro in the forefront of the economic recovery. When compared to other highly sought-after investment markets, Orange County's economic recovery is moving at a much faster rate, with more than 25,000 jobs added in the past 24 months. This continuous improvement in unemployment demonstrates the county's resilient job market and ability to support aggressive cap rates that will lead to increased yields as employment continues to improve.

METROPOLITAN UNEMPLOYMENT TRENDS

	New York	Dallas	Chicago	San Francisco	Orange County
2002-2007 Average Unemployment	5.4 percent	6.9 percent	5.7 percent	5.3 percent	4.2 percent
2011 Unemployment	8.4 percent	8.5 percent	11.3 percent	9.5 percent	8.7 percent
June 2012 Unemployment	8.2 percent	8.0 percent	10.6 percent	8.5 percent	7.9 percent

In addition to employment gains, population growth will also fortify apartment investment upside. In 2010, Orange County's population was 3,010,232. In 2011, Orange County's population increased by 19,226. By 2016, about 82,975 new residents will be added.

• The average number of people in an Orange County household is 3.0.

• Apartment demand increased by 3.6 percent from 2010 to 2011

In 2011, population growth was responsible for nearly 3,044 units of apartment absorption. By 2016, population growth will increase apartment demand by 12,564 units.

COUNTY OF ORANGE POPULATION

	Population	Change	Growth	Households Created	Increased Apartment Demand
2010	3,010,232				
2011	3,029,458	19,226	0.6 percent	6,425	2,863
2016	3,112,433	82,975	2.6 percent	28,187	12,564

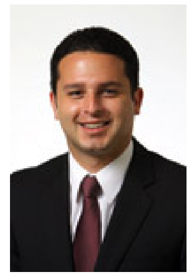
Orange County has historically been one of the most stable metros, with an average occupancy rate of 96 percent, and a recession-low of only 93.6 percent.

Apartments have historically been a very viable housing option for Orange County residents and are projected to become more popular in the housing crisis aftermath. Today's more stringent lending guidelines, borrower difficulty in raising the required down payment and concerns that housing values may decline further have kept many Orange County residents from capitalizing on low borrowing costs and attractive home pricing . Additionally, home ownership popularity is lagging as Millennials entering the workforce may find paying rent a more appealing option than owing a mortgage. Combine these new sentiments with Orange County's historically low affordability index, and it stands to reason that the suburban apartment markets like Orange County are poised for increased success in the near term.

— Joe Leon, managing director, Jones Lang LaSalle Capital Markets' Irvine office

RETAIL

"High barriers to entry" is the phrase that best describes what's driving the Orange County retail investment market. Retail in this coastal region continues to experience increasing rental rates, low vacancy and very strong absorption. Core population, high discretionary income, solid employment characteristics, a highly educated demographic and in-demand housing all contribute to the region's attraction. The high barrier to entry for new product keeps rental rates high and vacancy low. Cap rates – tracking at a sub 5 percent cap in some cases – are far lower than what we've been seeing in other areas.



Mousavi

There's a bifurcation between properties in Orange County/Los Angeles and the surrounding Inland Empire/Las Vegas/Phoenix areas. If you're willing to accept a 5 percent to 6 percent cap rate for an Inland Empire retail property, you'll accept a 4 percent cap in Orange County, where the market is insulated and value is protected. We're seeing local high-net-worth buyers look for opportunities especially in the single-tenant sector outside the coastal market in more inland cities like La Habra and Fullerton. In this case, the emphasis is on the quality of the tenant and the lease terms.

There are a lot of properties trading across the nation in markets such as Texas and Arizona, but a majority of California buyers desire to stay local and will accept a lower yield to remain in close proximity to their property. Cap rates should remain aggressive as investors seek safe alternatives to equities, fixed-income securities and cash equivalents.

Another strong trend is the amount of new retailers entering the market and the considerable amount of redevelopment and re-tenanting that is occurring. Triangle Square in Costa Mesa has converted from consumer goods to a destination entertainment center. It has added a 24 Hour Fitness, Saddle Ranch Chop House, El Corazon de Costa Mesa and H2O Sushi to its offerings, which already include Yard House and Sutra. This underscores the experience-type retail that the Orange County demographic is seeking. This also demonstrates a trend with several notable retailers, and some smaller and new market players entering the market. Orange County is known by retailers to be a strong, diverse and high-end market for expansion, especially for health and fitness and full-service restaurants.

— Mathew Mousavi, managing director, Investment Advisory Group, Faris Lee Investments in Irvine

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