Reis Observer

LOS ANGELES INDUSTRIAL MARKET

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THE ECONOMY

The Los Angeles County (Los Angeles Metropolitan Division) economy is still getting weaker, multiple data sources imply, with an increase in average income the only positive statistic. According to Current Employment Survey (CES) data from the Bureau of Labor Statistics (BLS), total non-farm payroll employment in the county was still 11,900 (0.3%) lower in November 2010 than it had been in November 2009, a period when employment in the U.S. as a whole rose 0.7% by this measure. According to household-based data from the BLS, the number of employed residents of the county, including the self employed, was down by more than 20,000 (0.5%) year-over-year in November, although the labor force increased by 32,600 (0.7%). With more and more people pushed into "freelance" or "independent contractor" arrangements rather than the wage and salary employees included in the CES, employment as measured by the household survey rose and fell substantially more than payroll employment in the recent cycle.

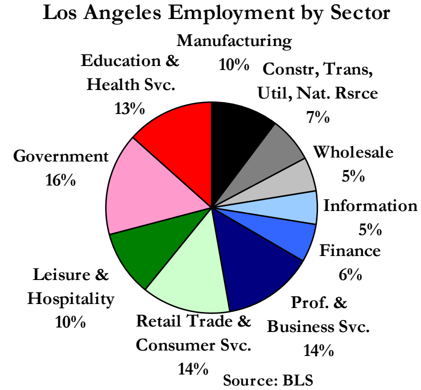
The big positive trend in Los Angeles is in average household income, according to Moody's Economy.com, indicating those who are better off are doing better still. After falling slightly in 2009, this figure increased 4.2% in 2010. The population, in addition, continues to rise at about the national average pace, by about 100,000 (1.1%) per year. Despite these figures, year-over-year employment trends in housing and consumer-related sectors are mixed as of November, according to CES data. The Construction sector lost another 8,200 jobs (7.6%) and Retail Trade lost 2,000 (0.5%), although Leisure and Hospitality gained 9,600 (2.5%). Within retail trade, the big box Grocery Store (plus 1,000 or 1.3%) and Department Store (plus 1,200 or 2.6%) industries fared better. On the housing front, "there's a growing fear the housing market may be headed for a double dip, and the December data for Los Angeles County should do little to dispel that notion," according to the *Los Angeles Business Journal*. "The median price of a house in the county fell to $345,000, off about 1 percent from both November and a year earlier," this source reported, and "annual homes sales fell 3.1% last year to 51,160 units, even though sales in the first half of the year were juiced by a federal tax credit that expired in April."

The strongest part of the economy is the Information sector, which is heavily concentrated in Los Angeles compared with the rest of the country. That sector added 17,800 jobs (8.9%) in the year to November, paced by an increase of 11,500 (8.9%) in the Motion Picture and Sound

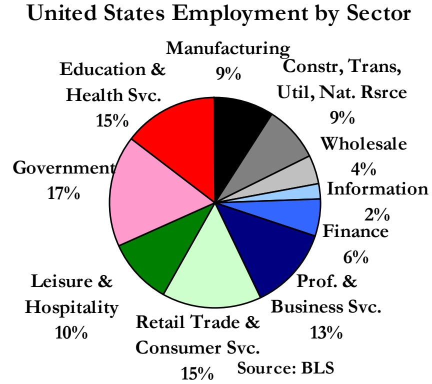
Employment:

- *BLS reports a seasonally unadjusted unemployment rate of 12.9% in November for the Los Angeles Metropolitan Division, up from 11.9% one year earlier.*
- *Total non-farm employment in Los Angeles was down 0.3% year-over-year in November, according the BLS.*
- *Moody's Economy.com reports a fourth quarter 2010 average household income of $130,716 for Los Angeles. Average household incomes of $120,040 and $123,558 are reported for the top metros in the nation and West region, respectively.*

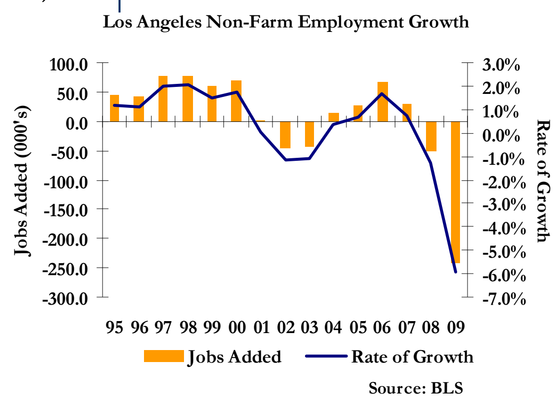
Los Angeles Employment by Sector



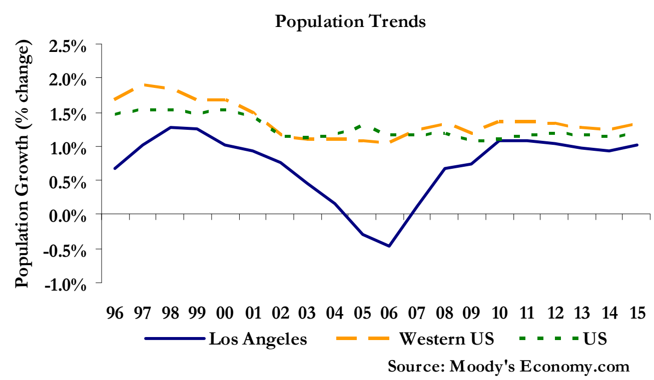
United States Employment by Sector



Recording industry. Job losses, meanwhile, have slowed to 400 (0.2%) in the Financial Activities sector and 2,900 (0.6%) in Professional and Business Services. Most components of those office-based sectors, moreover, are adding jobs, balanced by respective losses in Real Estate (minus 800 or 1.1%) and Management (headquarters) (4,700 or 9.1%). The bellwether Employment Services sector, which includes temporary workers, was up 1,300 jobs (1.6%) year-over-year.

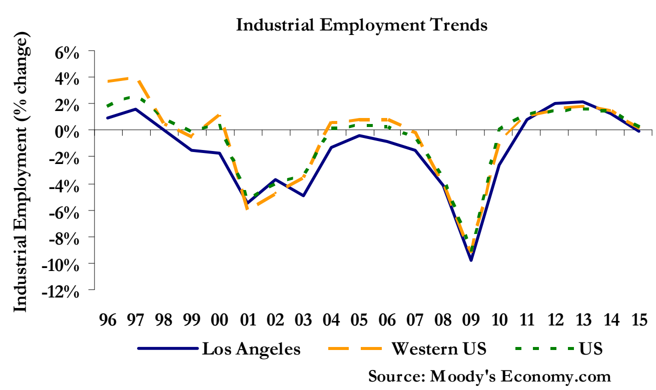


The weakest sector as measured by absolute job loss is Local Government, with a decrease of 17,300 (3.7%). In addition to their own difficulties, California's local governments have been affected by the fiscal crisis of the State of California. Proposition 13 limited local capacity to collect property taxes, and as a result a large share of local government revenues are received from the state. In addition, *CurbedLA* reported, the State is considering diverting local property tax revenues dedicated to redevelopment purposes to the state budget. "City and redevelopment officials around the state have reacted with disbelief that the governor would contemplate such an idea, saying it would deprive them of a vital tool for attracting businesses amid an economic crisis. But critics, including school and county officials, say the idea is welcome and overdue. They argue that although redevelopment has its merits, local leaders have overused it to subsidize questionable private development at the expense of basic public services," according to *Curbed.*



OUTLOOK

Moody's Economy.com forecasts a small increase of 30,600 (0.8%) jobs in Los Angeles County for 2011, offsetting the small loss in 2010 but leaving the huge hole created in 2008 and 2009. Not until 2015 is this area expected to regain the job levels seen in the banner years 2007 and 1989.

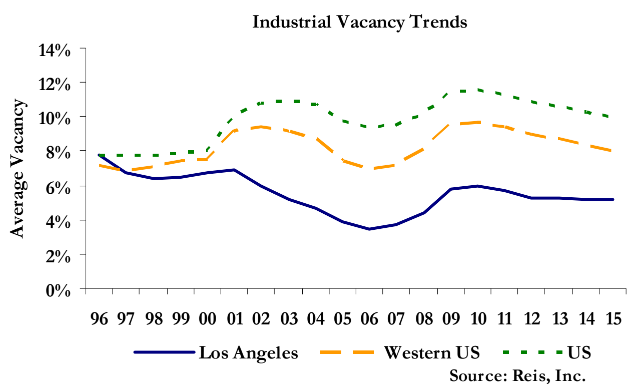


THE REAL ESTATE MARKET

The 812 million-square-foot, multi-tenant, non-manufacturing Los Angeles industrial market continued to have the lowest vacancy rate among the top markets tracked by Reis as of the end of 2010. But according to recently released annual data, it also had the eighth worst asking rent loss last year. While fundamentals deteriorated over the year as a whole, multiple market watchers report improving conditions in the fourth quarter, taken separately, and optimism for 2011.

OCCUPANCY

Reis reports a vacancy rate of 6.0% for 2010, up 20 basis points for the year and 250 basis points from the low point of 3.5% in 2006. Most of that increase occurred in 2009, in the depths of the recession, when the rate increased 140 basis points. The vacancy rate had last been as high as 6.0% in 2002; it had been higher than that every previous year since the start of the Reis database in 1980. So the current vacancy rate is not only still low compared with other markets, it is also still historically low for Los Angeles. But it is not low for the past decade in Los Angeles.



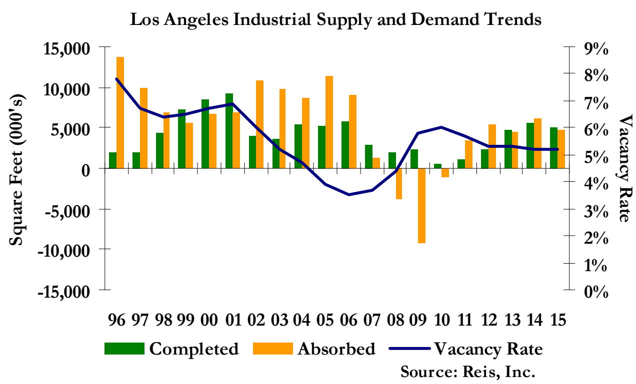
Colliers reports a vacancy rate of 5.2% for 880 million square feet in the fourth quarter of 2010, down from 5.4% one year earlier. Cushman & Wakefield reports occupancy gains in the fourth quarter for the first time since 2007, and a vacancy rate of 5.0% for 1 billion square feet. Reporting on 997 million square feet including owner-occupied and single-tenant space, Grubb & Ellis put the fourth quarter vacancy rate at 3.2%, down from a peak of 3.4% at first quarter 2010 after the rate "inched down throughout the year." This source predicts minimal vacancy rate declines in early 2011, followed by stabilization. Reis predicts the vacancy rate will fall for two years, to 5.7% at year-end 2011 and 5.3% at year-end 2012, before stabilizing at about that level through 2015.

Special Real Estate Factors:

- *It's still all about the ports in Los Angeles industrial. "Driven by the ports of Los Angeles and Long Beach, the Los Angeles industrial market has experienced a meaningful boost in activity since 2009" according to Western Real Estate Business. "Container volumes at the ports are up over 20 percent from last year's volumes and the Port of Los Angeles broke the all-time monthly record for container volume in August with more than 464,045 TEUs passing through its terminals." "Total Cargo activity at both the Ports of Los Angeles and Long Beach has made a positive rebound in 2010" according to Grubb & Ellis. "Driven primarily by increases in imports, as of November, the combined ports saw a 19.0% increase in year-over year volume. These positive port figures, coupled with a better than expected 2010 holiday season for retailers, lead many to believe the year ahead holds promise for a positive economic rebound."*

- *Environmental rules have increased the cost of trucking to and from the piers (drayage) according to Western, as the ports' clean-air action plan has "led to a shortage in equipment, driving traditional inland warehouse users closer to the ports. Several shipping lines have recently announced a plan to shift container chassis responsibility from the terminals to the trucking companies. This fundamental change in operation*

SUPPLY AND DEMAND



Net absorption was negative in 2010 for the third consecutive year, although the 1.1 million square feet of red ink was the smallest occupancy loss of the period. Total negative net absorption for the 2008 to 2010 period is more than 14 million square feet, far more than the negative 9.2 million in 1992 and 1993. The vacancy rate was higher in the early 1990s recession primarily because new supply was much greater in that era. The occupied inventory, however, was still higher at the end of 2010 than it had been at the end of 2004. And in the fourth quarter, according to local market watchers, net absorption was positive with figures cited between plus 500,000 and plus 1.5 million square feet.

New supply fell to just 521,000 square feet in 2010, according to Reis, by far the lowest recorded in a 31-year database. The previous low had been 1.3 million square feet in 1993, in the depths of the early 1990s recession. New supply had totaled around 2 million square feet in 2008 and 2009, even as net absorption turned sharply negative. The under construction totals cited by market watchers for fourth quarter varied from 500,000 to 1.5 million square feet, a small amount for industrial space in a market this large. Cushman & Wakefield reports the most space under construction, but much of it is in two build-to-suit owner-user projects, not competitive space.

Net absorption is forecast to turn positive in 2011 according to Reis, at 3.4 million square feet, while new supply is forecast to rise to over 1 million square feet. Vacancy is forecast to fall this year and in 2012 because net absorption is forecast to ramp up faster than new supply. They are both projected to stabilize at around 5 million square feet per year (roundly speaking) from 2013 to 2015. That would be about half the demand seen in the strong 2002 to 2006 time span, with about the same level of new supply. Thus, the sub-5.0% vacancy rates of 2004 to 2008 are not expected to repeat until, perhaps, beyond the forecast period.

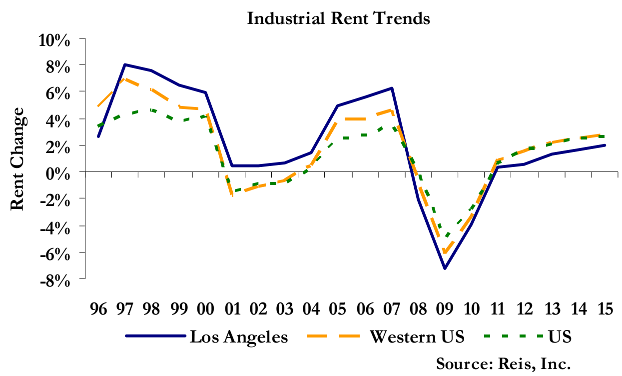
Special Real Estate Factors:
Continued

has trucking companies rethinking their real estate needs. Trucks that would otherwise pick up a container and chassis from the terminal will now be required to lease, maintain and, most importantly, provide sufficient real estate to store the chassis. With industrial zoned land already at a premium, trucking company demand has bid up the price of land for sale and lease near 2006 levels."

- *"The debate over whether to build a $50 million shipbuilding and repair business at the Port of Los Angeles will now be heard by the City Council," according to The Daily Breeze. A proposal by Long Beach-based Gambol Industries to open a shipyard on the site of the shuttered Southwest Marine slips at Terminal Island had been unanimously rejected by the Board of Harbor Commissioners. The shipyard would provide 1,000 jobs, but "Harbor Department officials have repeatedly warned that building the shipyard could delay the port's ongoing Main Channel deepening project by two to three years. Port officials want to dump massive amounts of dirt dredged from the Main Channel into the unused slips at the Southwest Marine terminal. The sludge would be sealed behind a rock dike that's already gained permits from state and federal regulators. It took port officials about five*

RENTS

Although the recession did not push up the Los Angeles vacancy rate to a high level by previous or national standards, the decreases in rents were severe. In 2010 the average asking rent fell 3.9% to $5.93 psf according to Reis, while the average effective rent decreased 5.0% to $5.48 psf. It was the third consecutive annual decline, with the effective average dropping 16.2% during the 2008 to 2010 period. Rents fell more in the early 1990s however, and thanks to strong gains from 2005 to 2007, the effective average is about the same as it had been in 2004.



Although Grubb & Ellis reports an additional decrease in the average asking rent in the fourth quarter of 2010, to $5.28 psf, Cushman & Wakefield and Colliers report flat rents at $6.00 and $5.64, psf respectively. Cushman & Wakefield predicts that rents will continue to trend downward in 2011. Reis, on the other hand, predicts rents will stabilize in 2011, rising by 0.3% by both measures, with additional improvement expected to be slow. With industrial rents rising by no more than 2.5%, and generally well less than that amount, through 2015, Los Angeles is forecast to trail the U.S. and West region averages, reversing the relative outperformance of the mid-2000s.

According to Reis Transaction Analytics, industrial property sales ran at the same depressed rate in 2010 as they had in 2009—and well below the levels of the previous few years. Last year saw 140 sales for $866 million at a mean price of $80 psf. That mean price is down from $87 psf in 2009, when the dollar value of sales was $847 million, and from $129 psf in both 2007 and 2008, when sales volumes totaled $3.3 and $1.7 billion respectively. The fourth quarter of 2010, moreover, showed the lowest sales volume of the year as just 22 properties sold for $149 million at a mean price of $114 psf.

Special Real Estate Factors:
Continued

years to find an appropriate place to store the contaminated soil. Any delays to the channel-deepening project would have a domino effect and impede the ongoing expansion of the TraPac and China Shipping terminals."

- *The massive cranes these companies would use for larger ships have already arrived at the port for installation according to the Los Angeles Business Journal. While the battle over dredging continues, the Los Angeles and Long Beach ports face a "deadline" to make improvements or lose more business. "A big deadline is 2014, when the Panama Canal is expected to complete a $5 billion widening project giving large freighters loaded with goods from Asia bound for the Eastern United States the option of bypassing Southern California altogether. Several ports – including those in Mobile, Ala.; Jacksonville, Fla.; Savannah, Ga.; and Charleston, S.C. – are already undergoing major renovations designed to attract those ships." Despite the addition of alternatives in the future, "China Shipping – in addition to adding the massive cranes – is spending $121 million to double its footprint to 142 acres at the dock as well as construct new berths and expand its wharf to accommodate more business, including the bigger ships. Another leading terminal operator – Trapac Inc. – is spending $274 million to extend its wharves, install new cranes and make other improvements, also partly in*

SUBMARKETS

The South Bay area is the home of the ports of Los Angeles and Long Beach, and the key to the region's economic prosperity, although distribution centers are located throughout the county and further inland. The San Gabriel Valley contains more traditional manufacturing, along with high-tech and distribution space while the San Fernando Valley is more tech and local-market oriented. Labor-intensive light manufacturing, including apparel and toys, clusters in the central areas.

San Fernando Valley/Ventura County

- "In Q4 2010, the San Fernando Valley & Ventura County industrial market experienced an additional -52,800 square feet of net absorption which caused the total vacancy rate to increase 10 basis points to 5.2%." according to Colliers.

- The availability rate, the amount of space being marketed, fell according to this source. "The higher level of sales and leasing activity combined with the continued drop in industrial availability is an indication that the San Fernando Valley & Ventura County industrial market may be bottoming. On the other hand, whether the market is beginning to recover is a completely different question."

- The weighted average asking rental rates for direct space remained flat at $6.48 psf, "the first time in two years that rents have not declined."

- Lease highlights, according to Colliers, include the 229,500 square feet taken by Deluxe Media at 28355 W. Witherspoon Pkwy in Valencia, the 155,000 square feet renewed by Thibiant International renewing 20320-20350 Prairie St & 9315 Oso Ave in Chatsworth, the 111,700 square feet taken by AG Machining at 609 Science Dr. in Moorpark.

- The Deluxe Media lease was the only one to make the top ten reported by Cushman & Wakefield in Los Angeles. This source puts year-to-date net absorption at minus 2.2 million square feet for 220.5 million square feet of inventory in North Los Angeles.

- Grubb & Ellis reports a 3.7% fourth quarter 2010 vacancy rate for 190 million square feet in its LA North submarket. The average asking rent for warehouse space is given as $6.12 psf, down from $6.24 psf,

Special Real Estate Factors:
Continued

anticipation of the big ships." The dredging project would put the channel at 53 feet rather than 45.

- *Meanwhile the aerospace industry, a major part of the Los Angeles industrial scene before the massive downsizing of the early 1990s, continues to face attrition. According to the Business Journal "Boeing said Thursday it will cut 900 jobs in Long Beach as part of the elimination of 1,100 jobs from its C-17 Globemaster III airlifters program as the aerospace giant reduces the production rate from 13 to 10 per year." Sales of C-17s have faced cutbacks in procurement by the Pentagon, but Boeing still has overseas sales. By "reducing the number of C-17s we deliver every year — and doing that with a smaller work force — will allow us to keep the production line open beyond 2012, protect jobs, and give potential customers more time to finalize their airlift requirements," according to the company. "The C-17 program, which supports roughly 25,000 supplier jobs in 44 states, has an annual economic impact of $5.8 billion. Now in its 18th year of service, the C-17 has supported numerous military transport, humanitarian and disaster-relief missions worldwide." The cargo plane is being heavily used by the U.S. military in Afghanistan. Of a total of 226 in service, 206 are owned by the U.S. Air Force.*

and the asking average for R&D space is $9.84 psf, down from $9.96 psf.

<u>*San Gabriel Valley*</u>

- "For the fourth quarter in a row, the historically tight industrial market experienced a slight dip in vacancies, to 3.6%," according to the *Los Angeles Business Journal* citing Grubb & Ellis Co. "That all amounts to a seven-tenths of a point drop compared with a year earlier, making it the most improved industrial submarket in Los Angeles County with the exception of downtown and the rest of Central Los Angeles. Sales and lease activity nearly doubled since the third quarter to 1.79 million square feet."

- Grubb & Ellis puts the average asking rent at $4.92 psf for warehouse/distribution space and $9.24 psf for R&D/flex the San Gabriel Valley. Colliers, which also cites positive net absorption, puts the average asking rent at $4.92 psf, down slightly from the previous quarter.

- "This quarter," according to Colliers, "Overton Moore Properties purchased a portfolio of four buildings totaling 318,400 square feet in the City of Industry for $14 million ($44 PSF). Also this quarter, Huy Fong Foods broke ground on their 655,000-square-foot industrial headquarters which is scheduled for completion in late 2011." The 23-acre site, at Azusa Canyon Road and Cypress Street, is owned by the company.

- "The market making the most progress has been the Industry submarket, which also suffered the greatest losses in the past two years" according to Colliers. "The vacancy rate in the Industry submarket fell from 5.4% last quarter to currently stand at 4.6%. This was due to several large leases being signed this quarter as well as the completion of a 200,000 SF build-to-suit project for Troy Lighting."

- "Main events" cited by the *Business Journal* include the completion of Peck Center, a 150,000-square-foot, 40.0% leased industrial business park at 2300 Peck Road in the City of Industry. "Tenants include distribution companies, a printer, an auto parts distributorship and an electronics manufacturer."

- According Colliers and Cushman & Wakefield, the San Gabriel Valley accounts for the majority of the space under construction in Los Angeles County.

- "Port Logistics Group, which provides logistic services for companies that do business at the ports, leased a 449,000-square-foot distribution center in the City of Industry from ProLogis," according to the *Business Journal*. This was the largest lease of the quarter in the area according to Cushman & Wakefield, which put a 408,000-square-foot lease by Pilot Automotive at 12000 Temple Avenue second.

South Bay

- "The vacancy rate in the South Bay industrial market fell 20 basis points to 5.1%" on 408,000 square feet of positive net absorption," according to Colliers. "This marks the third straight quarter of positive industrial demand. Year-to-date, net absorption was negative 377,700 square feet due to significant losses in the first quarter of this year." This source put the asking average at $6.24 psf, unchanged from the prior quarter.

- "The rents in the South Bay for Class A larger buildings have held up during the meltdown," a broker told the *Business Journal*. "The vacancy (rate) is extremely low historically compared to (nearby) Mid-Cities where the rents have not held up by any stretch."

- "ProLogis, a Denver-based warehouse developer, owner and manager, broke ground in November on a 270,764-square-foot facility at 2211 E. Carson St. in Carson," according to this source. "The building is reportedly the first spec industrial construction in seven quarters in the market."

- The quarter's largest leases, according to Cushman & Wakefield, were for 285,000 square feet by CEVA Freight LLC at 18120 Bishop Avenue and 267,000 square feet by NYK Logistics at 771 Watson Center Road. This source reports a vacancy rate of 5.4% and a direct weighted average net rental rate for distribution space of $6.12 psf in South Bay.

- "Many large third party logistics companies have been enticed by declining asking rates in key submarkets, such as the South Bay, and are locking in long term deals in an attempt to secure these discounted rates and stay ahead of the market rebound," according to Grubb & Ellis.

Central Los Angeles

- This submarket was skin-tight during the mid-2000s, with virtually no vacancy. As of the fourth quarter market watchers are reporting different trends.

- "Industrial demand remained negative as 248,600 square feet was returned vacant to the market," according Colliers, which put the vacancy rate at 5.3%, up from 5.2%. "This marks the 14th consecutive quarter of negative net absorption and diminishing industrial demand in the Central Los Angeles industrial market."

- "Asking rental rates have continued to fall," according to this source, which quotes a figure of $5.16 psf.

- Grubb & Ellis, on the other hand, cites net absorption at plus 744,000 square feet for fourth quarter and plus 1.6 million square feet for all of 2010. Note that this source includes owner-occupied space in its inventory. The vacancy rate is just 2.3% according to G&E, with an asking rent for warehouse/distribution space at $4.56 psf.

- Cushman & Wakefield, however, also cites vacancy rising to 4.2%, "the highest level in five years," and falling rents. User sales activity has been strong in Central Los Angeles according to this source, led by a Forever 21 purchase from Macy's of a 1.56 million-square-foot property at 3880 N. Mission Road in Los Angeles for $42 million. It was the largest sale of the quarter according to C&W.

- "The largest lease of the quarter," according to Colliers "was FCCH Mailing Services leasing a 109,600-square-foot building in Commerce and National Trading Enterprising occupying 90,000 square feet in Los Angles."

- "Since the Central Los Angeles industrial market is the oldest industrial market in the region," according to Colliers, "rents are often quoted on an industrial gross basis, which does not pass the burden of insurance, taxes and maintenance to the tenant. For these older buildings, the asking rental rate has actually declined over the quarter," to $4.08 psf full service.

OUTLOOK

According to the USC Casden forecast, as reported by *Professional Services Close-Up*, the outlook for Los Angeles industrial space is much stronger than it is for Los Angeles office space. "The industrial sector is showing stronger signs of recovery across the board," according to this source. "The strong Chinese and Indian economies, combined with the weakened U.S. dollar, have increased demand for U.S. manufactured goods and greatly increased port traffic." As a result "with the nation's biggest port and tightest industrial market, industrial rents are expected to increase by 10.5% over the next two years," as the vacancy rate falls to 3.3%. The displacement of industrial users to the Inland Empire may resume, according to this source.

Reis is not that optimistic. Although the vacancy rate is forecast to begin falling in 2011, rent gains are forecast to be minimal in 2011 and moderate through the end of the forecast period in 2015. In the final years of the period, new supply is forecast to rise to approximately the level of net demand, allowing the vacancy rate to level off above 5.0%. While a vast improvement over 2008 to 2010, the forecast period is not expected to see a repeat of the mid-2000s boom.