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Slightly guarded optimism trumpets in the 2012 California office market

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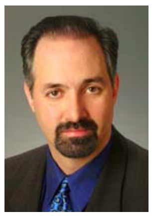

The last two quarters of 2011 produced significant activity in the California office market. The 2012 market should, barring any significant national or international economic missteps, be even more robust.

2011 witnessed a significant increase in investment sales activity. Investors, such as Kilroy Realty Corp. and Hudson Pacific Properties, were particularly focused on core and core plus acquisitions in markets such as San Francisco, West Los Angeles and the Silicon Valley. These markets showed rental rate stability, and in some cases, upward rental rate movement for investors that wanted stable, long-term investments with the potential for asset appreciation even at what seemed to be high acquisition prices. This was the case even as office REIT (real estate investment trust) stocks experienced some volatility in late 2011.

Sales volume in millions of dollars spent was back to 2004 levels, a healthy pace that had preceded the unprecedented sales volume of 2005 to 2007, which was largely driven by portfolio acquisitions. This time around, however, Northern California, as opposed to Southern California, is where the activity is most robust. This is largely due to the increased rental rates found in the South of Market area of the city of San Francisco and the Silicon Valley markets.

As we begin 2012, the following will be true about the California office market: Investors have massive liquidity that must be put to work to gain returns. This includes private equity shops that are sitting on significantly sized and largely untapped equity funds and REITs that have a very low cost of funds and require little to no leverage. REIT stocks in 2011 and into 2012 are greatly outperforming the Standard & Poor's 500 and the entire NASDAQ, and although office REIT stocks have generally trailed other REIT stocks, office REIT stocks have been up in the last several months. This investor confidence allows REITs to raise more equity and take on more debt while investing in real estate.

Also, the amount of debt that is available for real estate is massive, mostly originating from life companies, U.S. banks and the resurgent commercial mortgage backed security markets. It is estimated that $50 billion of CMBS debt issuances will be available in 2012. This is back to 2002 levels and on the way to the very respectable 2003 level of $78 billion. Life companies could produce another $50 billion of debt, and U.S. banks, which have significant liquidity due to limited corporate and consumer borrowing demands, will add to these massive debt availability amounts.

Why are these funds chasing real estate, especially office product, instead of corporate or government investments? The answer is simple. Returns on debt instruments, such as U.S. Treasuries and CMBS debt, remain low for investors. Ten-year and five-year treasuries currently yield returns of less than 2 percent and 1 percent, respectively. Furthermore, corporate investments are not highly available since corporate America is, for the most part, liquid and not in the borrowing mode. So investors that are seeking moderate, stable returns should spend their money in core real estate. As we know, core and core plus markets with rental stability and, in some cases, growth, have shown significant investment activity throughout 2011. It is much less attractive to invest in U.S. treasuries, CMBS debt with low returns, when you can invest in Class A core well-leased office product and get moderate returns in the 6 percent to 8 percent range.

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What office product will be available to quench this investment thirst? One answer is non-performing CMBS, bank and life company loans. Loan maturities for such lenders in 2012 are estimated to exceed $350 billion. Furthermore, past due loans for such lenders as of the end of fourth quarter of 2011 exceeded $140 billion with at least $80 billion of CMBS loans in special servicing.

These loan maturity dates and loan defaults will certainly put stress on both lenders and borrowers alike to cause the mortgaged properties to be "short" sold by the lenders and borrowers, or in the case of a foreclosure, by the foreclosing lender. Although we have seen in 2007 through 2011 that such circumstances do not necessarily lead to the large scale transfer of such real estate, it does lead to the movement of those office properties that are too far under water to warrant a lender/borrower work out. Also, 2010 to 2011 showed us that some lenders, especially life companies and U.S. banks, are less interested in workouts, and given rising purchase prices, will foreclose and sell such encumbered assets.

Before we ready ourselves for significant sales activity in the California office market, we must pay homage to some international and national macro-economic conditions that could sink our 2012 real estate party. The big party crashers could include political or military driven unrest in the Middle East, especially Iran, which could affect the supply of oil and cause a significant rise in oil prices. Such an effect occurred during the war with Iraq and caused a spike in crude oil prices that exceeds today's cost by over 40 percent. This would have a significant impact on the oil dependent U.S. economy and an indirect negative impact on real estate values and investments. The U.S. federal government deficit is also at a significant high of over $1,250 billion, and if consumers and investors lose confidence in the U.S. bond market, a meltdown could occur and interests rates across the board would certainly rise significantly. In turn, the real estate market, the success of which is directly tied to low interest rates, would be significantly affected.

Also, as we all know, a failure of lenders, governments and investors to bail out Greece could lead to a financial meltdown in that country, with a direct negative economic effect on the rest of Europe and a significant indirect negative economic affect on the U.S. economy. This European economic threat is further enhanced by the fact that the government debts of Spain and Italy, which are twice and four times the size of Greece's debt, respectively, are probably too big for a bail out.

Lastly, the Chinese economy, which has shown amazing growth in productivity and borrowing over the last several years coupled with significant volatility, could experience a meltdown and lead to a significant negative ripple affect on the U.S. economy. Fortunately, for the moment, most of the renowned economic prognosticators are not predicting that any of these national or international real estate market game changes will occur in 2012.

The last step is to focus on how the foregoing specifically effects the office markets of California and its prime office investors. The hottest core market with rental rate stability and growth will continue to be San Francisco. That market will lead the charge in both rental rate growth and also investment sales activity and pricing. West Los Angeles, which has stabilized at high rental rates after its meteoric rental rate rise that ended in 2007, will be very attractive, but might end up lacking in sales volume and supply because its owners for the most part are reluctant sellers - instead, they are long term holders such as REIT's and pension fund advisors. Silicon Valley will be one of the most active markets as it has bounced back with rising rents, low vacancy rates and some recent investment sales activity at high pricing.

These markets will continue to be focal points of institutional office investors in 2012. One of the markets that could sneak in to share some of the attention are portions of San Diego's North County. These markets enjoy many of the same tenant driven advantages of San Francisco's South of Market, Santa Monica and parts of the Silicon Valley, and are starting to achieve rental rate stability and growth.

The prominent office players will continue to be the REITs such as Kilroy Realty

Corp., Hudson Pacific Properties, Shorenstein Properties, and Boston Properties Co., and the pension fund advisors and co-investors, such as The Blackstone Group, J. P. Morgan Real Estate, Beacon Capital Partners, and Lincoln Property Co. These institutional, savvy buyers will continue to be in the hunt throughout 2012. With some luck, 2012 will be a very active year for California office investment.