






**Commercial Real Estate Economics, Values
and Mortgage Trends 2009 - 2010**

Prepared for
Santa Clara University (SCU) – Real Estate Network

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Johnson Souza Group, Inc

- Over 20 years of real estate economic and financial research, and institutional due diligence underwriting. Specializes in apartment and commercial market research, valuation and brokerage services.
- Offering tax deferred vehicles: 1031 Exchanges, Tenants in Common (TIC), Deferred Sales Trusts (DST), etc.; and real estate related investments: partnerships, funds, REITs, etc.

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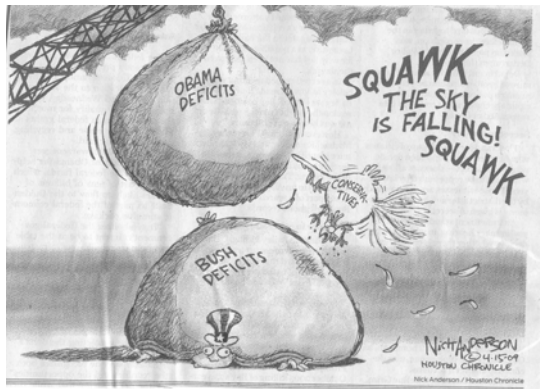
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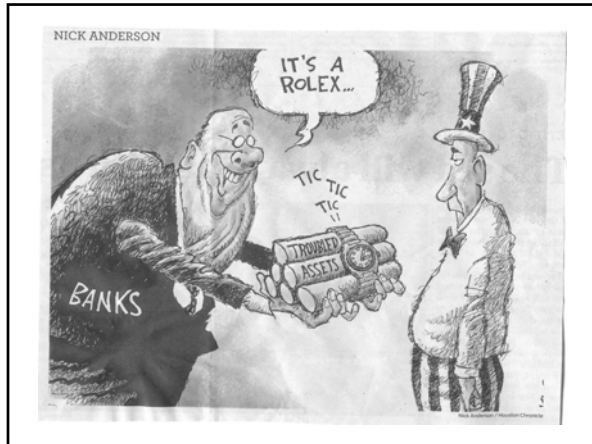
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Outline

- Introduction
- Political Economy and Philosophy of Commercial Real Estate Investment
- Commercial Real Estate Supply/Demand Analysis
- Modern Real Estate Portfolio Theory (MREPT)
- Fiscal/Monetary Policy and Financial Institutional Analysis
- Business and Real Estate Indicators
- Commercial Real Estate Capital Market Fundamentals
- Conclusions/Appendix







Business-Market Cycle Forecast

- **Economy in decline/trough phase:** employment contraction decelerating (36-to-60 month trough); worst case 7 year trough, 7 year stagnation.
- **Next 12-to-24 months:** Cap Rates up +200 bps, NOIs down 16%-to-20%, sales volumes down 75%-to-95%, values down 30%-to-50%, construction down 18%, rising defaults and delinquencies.
- **Business-commercial real estate cycle:** slow recovery 2010 – 2013, growth 2014 – 2015 (rent/value spikes) and peak 2016 – 2018.
- **Target markets for commercial investment 2009-2010:**
 - Urban-Infill/Supply-Constrained/Transit Oriented/Diverse-Growth Economic Base Submarkets**
 - Downtown San Francisco/San Jose; I-680/880 Corridors-Walnut Creek/San Ramon (Pleasanton/Fremont); SF Peninsula-Redwood City/Palo Alto (Marin/Santa Cruz)**

Commercial Demand (Economic Base)

Target Geographies-Submarkets by Industry Sector:

- High-tech and Bio-tech Manufacturing (SF/Oak)
- Alternative and Clean Energy Technologies (SF/SJ)
- Healthcare-Information Systems Services (SF/SJ/Sac)
- Financial Services and Venture Capital (SF/SM)
- Telecommunications/Networking (SJ)
- Multimedia and Entertainment (SF/Marin)
- Internet and Software Programming (SF/SJ/Oak)
- International Trade and Tourism (SF/SJ/Sac)
- Construction and Engineering Services (SF/SJ/Sac)
- Education and Government Services (SF/SJ/Oak/Sac)
- Defense (SJ/Sac)

Geographic Comparative Advantages

Long run commercial market fundamentals:

- Low commercial market affordability (high costs)
- Scarcity of developable land (supply constraints)
- High concentrations of wealth/education
- High quality of life amenities
- Strong demographic trends:
 - Growing population of Empty-Nesters and Echo-Boomers, positive migration trends

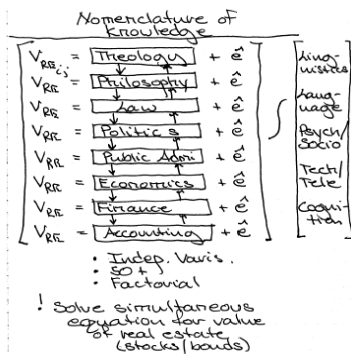
**Political Philosophy & Economy
Commercial Real Estate Investment**

Institutional Foundations for Efficient Capital Markets

“Efficient real estate and securities capital markets require strong public and private sector cooperation, disclosure of government and corporate financial conditions, and institutional and individual investor confidence in financial and political institutions.”

Lawrence Souza

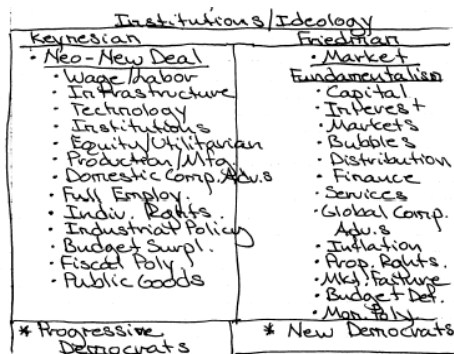
Real Estate in a Social, Cultural and Economic Context



Interdisciplinary/Cross-Sectional Approach to Real Estate Market Analysis

The Political Philosophy and Economy of Commercial Real Estate Investment

Binary Ideological Extremes



Interdisciplinary/Cross-Sectional Approach to Real Estate Market Analysis

Post-Modern Philosophy - Institutional Deconstruction

- Loss of Civil Liberties - Personal/Individual/Property Rights
- Lack of Governmental Transparency and Accountability
- Dismantling of Social Welfare State and Safety Net
- Direct Input into Policy Development by Special Interests
- Redistribution and Concentration of Wealth (Privatization)
- Lack of Access to Democratic Institutions and Legal System
- Freedom of Speech and Press Limitations (Censorship)
- Unification of Church and State, attack on science

“Institutional deconstruction is the dismantling of pluralistic and democratic institutions by powerful interests within society. The goal is to “deconstruct” these institutions, and replace them with new authoritarian institutions that enforce and redistribute private property rights to privileged interests, at any cost.”

Jacques Derrida, Martin Heidegger, Friedrich Nietzsche, Larry Souza, Et. Al.

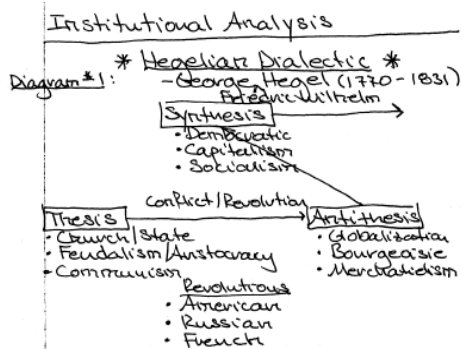
Greenspan Critique: Labor vs. Capital

- Greenspan developed a New Business Cycle that privileges financial-capital markets over labor markets.
- Major shift to *preemptive monetary policy strikes* toward *inflation targeting*, and away from *full employment-real wage growth targeting* (Paul Volcker -> Ben Bernanke).
- Foundation of monetary policy was deregulation, a financial boom in the stock and real estate markets and free trade, driving up consumer consumption and debt levels.
- **Results:** Cycle marked by deindustrialization, growing trade deficits, financial-asset market price bubbles, dollar overvaluation, L-T decline real wage growth, growing household debt levels, under investment by business in capital stock
- **Risks:** Fragile economy-recovery, high debt levels, under performing labor markets, exposure to financial market corrections, moral hazard – Fed intervention to rescue markets

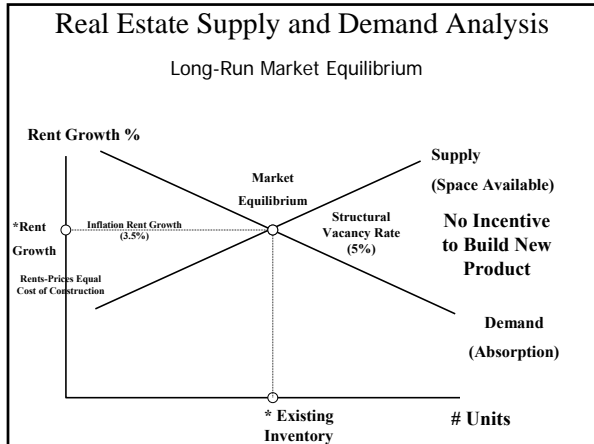
Thomas Palley, Challenge, Nov.-Dec. 2005.

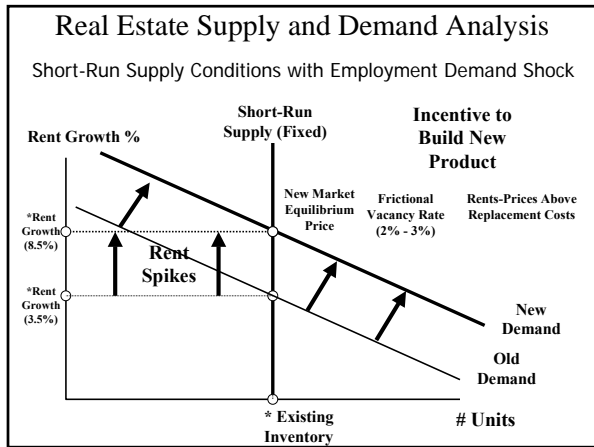
The Political Philosophy and Economy of Commercial Real Estate Investment

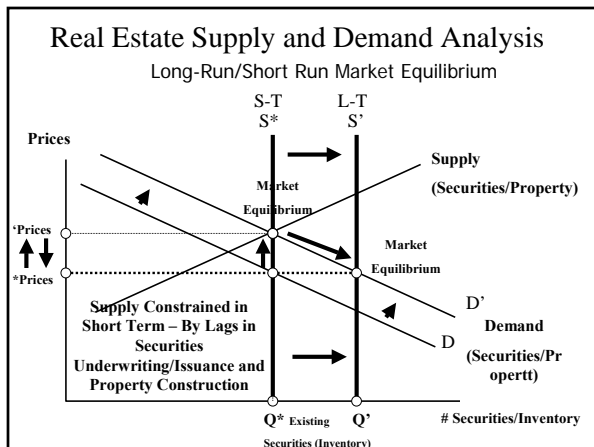
Classical Hegelian Dialectical Analysis

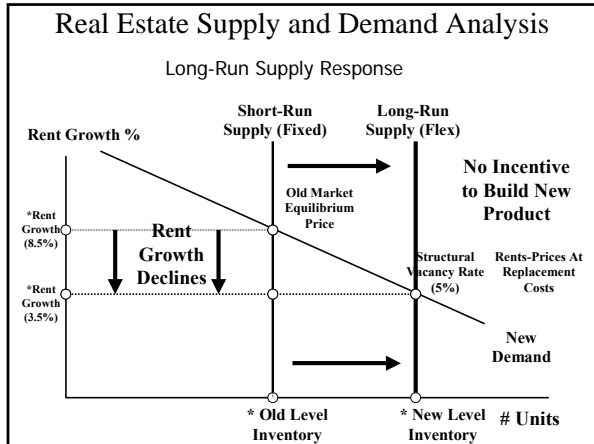


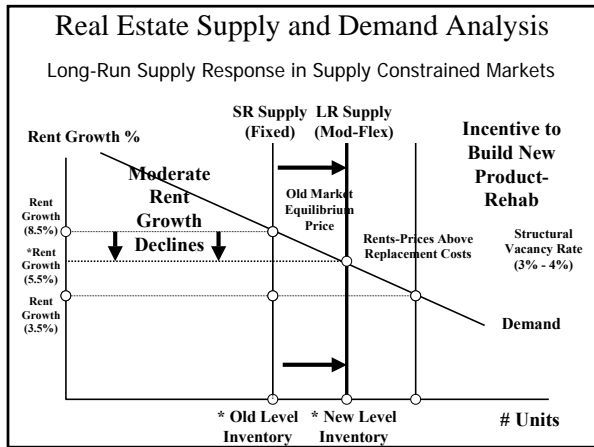
Interdisciplinary/Cross-Sectional Approach to Real Estate Market Analysis

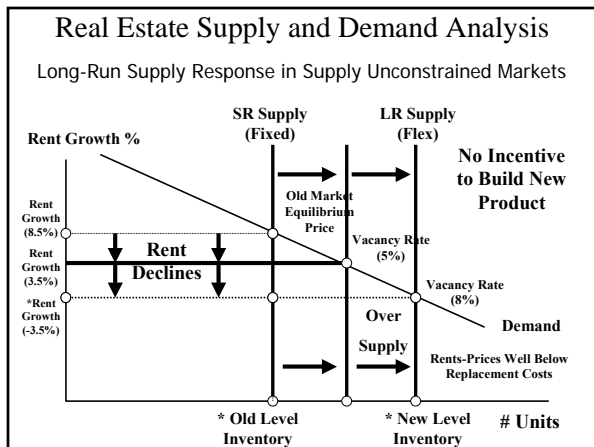


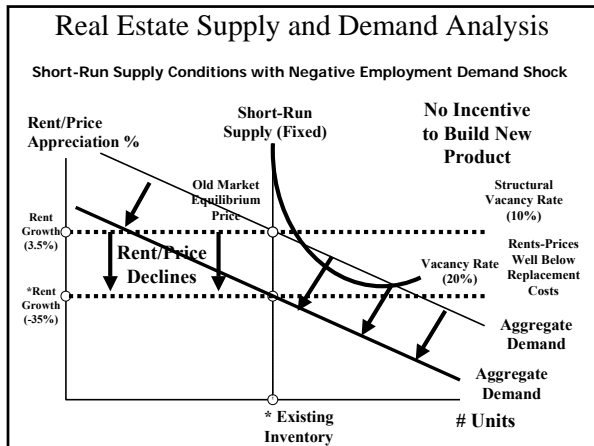


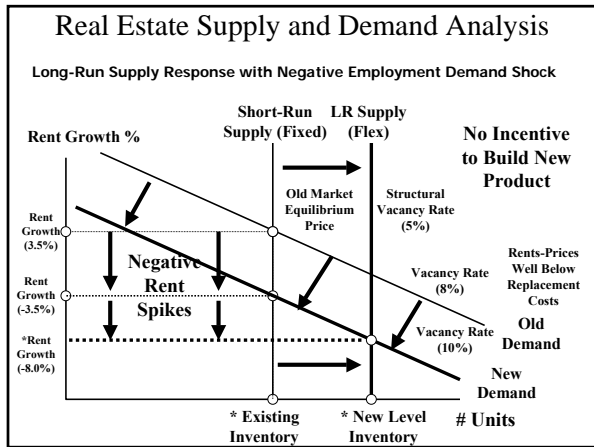


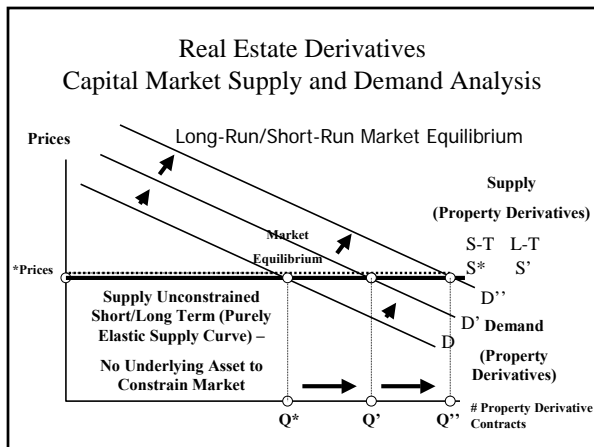




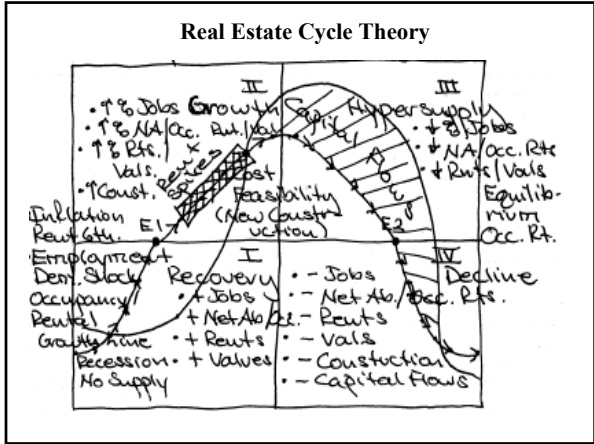








Real Estate Cycle Theory



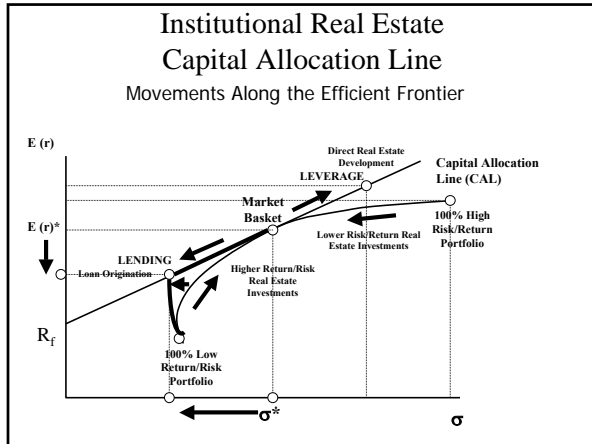
MODERN REAL ESTATE PORTFOLIO THEORY (MREPT)



Institutional Real Estate Capital Market Theory

Size of Commercial Real Estate Capital Markets:

Global Direct:	\$10 –to- \$15 trillion
U.S. Direct:	\$5.3 –to- \$6.3 trillion - \$100 bill. On side-lines
REITs:	\$150 –to- \$330 billion (Equity)
CMBS:	0 –to- \$170 billion Annual Issuance – 24% per year
Bank Loans:	\$1.8 trillion Annual Origination (Commercial)
Derivatives:	\$5.4 trillion – Commodity – 52% per year growth
RE Derivatives:	\$53-to-\$106 billion in 7-to-14 years (projected)



Applications In Portfolio Theory

Balanced Conditions for Long Periods:

- LA/Orange County/Riverside
- San Diego
- Bay Area
- Seattle
- Low Vacancy Rates
- High Effective Rents
- Prices Above Replacement
- Job Growth
- In-Migration
- Housing Demand
- Positive Net Absorption

Modest Conditions of Over/Under Supply:

- Sacramento
- Salt Lake City
- Portland
- Denver

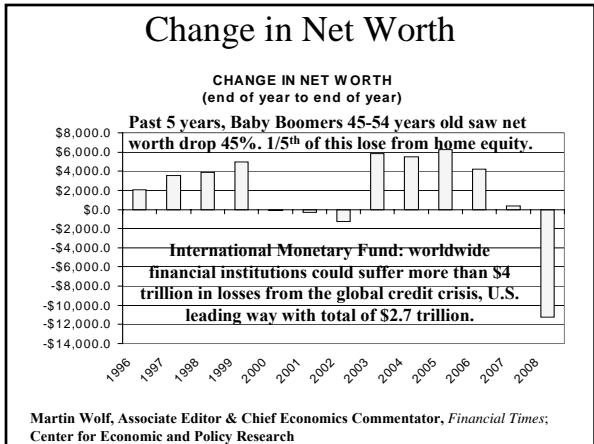
Metro	Average Annual Return	Standard Deviation	Risk-Adjusted Rate of Return
Orange County	14.5%	7.6%	1.9
SF Bay Area	15.5%	8.8%	1.7
Seattle	14.3%	9.3%	1.5
San Diego	13.7%	9.4%	1.4
Los Angeles	14.4%	9.9%	1.4
Sacramento	13.8%	11.0%	1.3
Denver	12.0%	11.2%	1.3
Portland	12.5%	10.0%	1.3
Salt Lake City	13.0%	11.0%	1.2
Phoenix	14.1%	11.4%	1.2
Tucson	14.1%	11.4%	1.2
Riverside	11.0%	11.9%	1.0
Las Vegas	5.1%	6.0%	0.8
Albuquerque	2.4%	4.4%	0.5

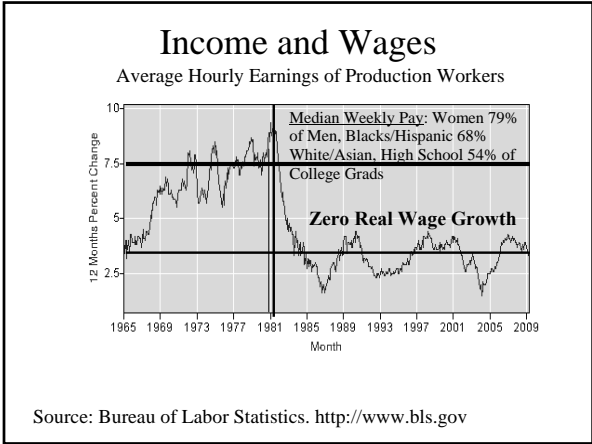
Risk-Adjusted Rates of Return are calculated by dividing the Total Average Annual Rate of Return by the Standard Deviation (Risk) for each metro area. The Risk-Adjusted Rate of Return measures the amount of return for each unit of risk. For example Orange County provides 1.7 units of return for each unit of risk. Total Returns are calculated by the year-over-year change in sales price per square foot on a quarterly basis (Capital Appreciation) plus the annualized cap rate (Income Return) per quarter. Sources: National Real Estate Index (NREI) and BRE Properties Research Department.

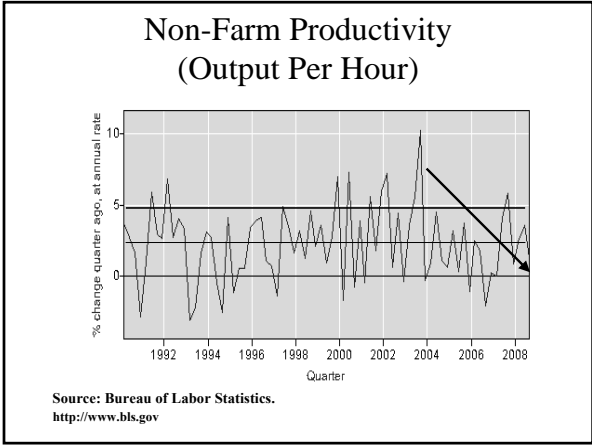
Fiscal/Monetary Policy and Financial Institutional Analysis

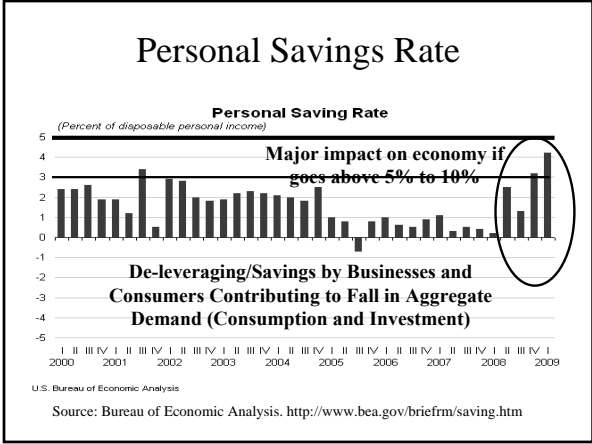


Business and
Real Estate Indicators

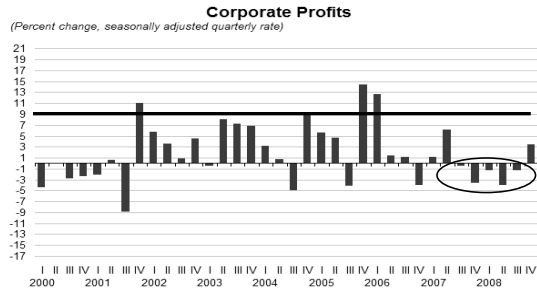








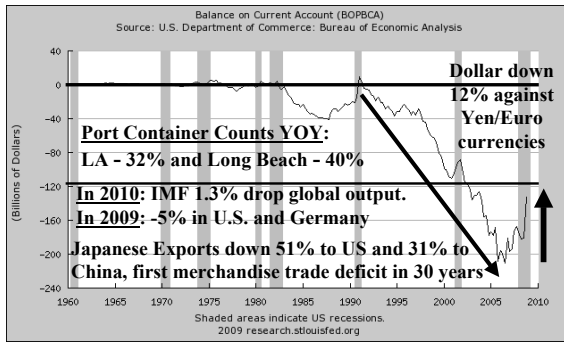
Corporate Profits



U.S. Bureau of Economic Analysis

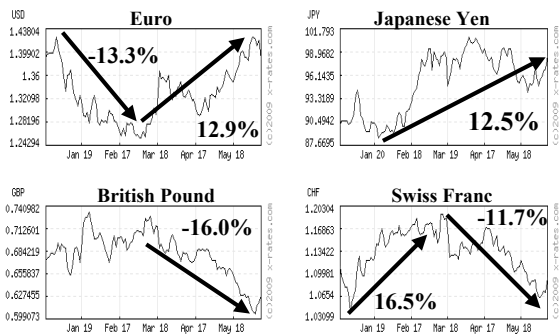
<http://www.bea.gov/briefm/corpprof.htm>

Balance of Trade



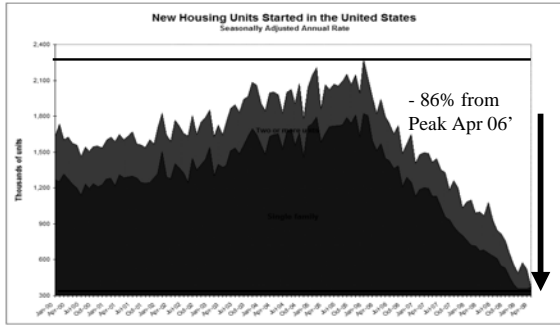
Sources: U.S. Department of Commerce; Bureau of Economic Analysis
<http://research.stlouisfed.org/fred2/series/BOPBCA/13>

Exchange Rates (2009)



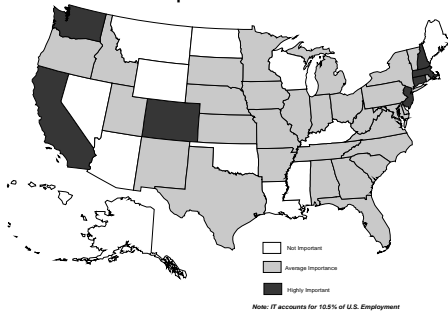
<http://www.x-rates.com/d/USD/EUR/graph120.html>

New Housing Starts

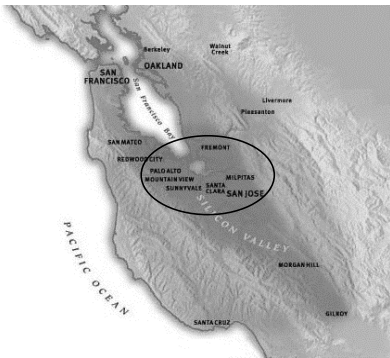


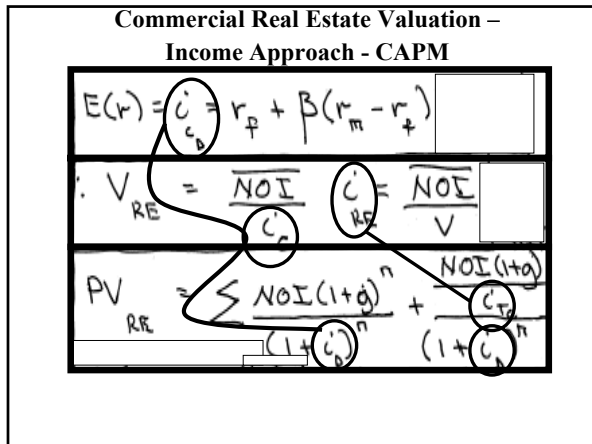
Source: United States Census Bureau. <http://www.census.gov/briefmr/esbr/www/esbr020.html>

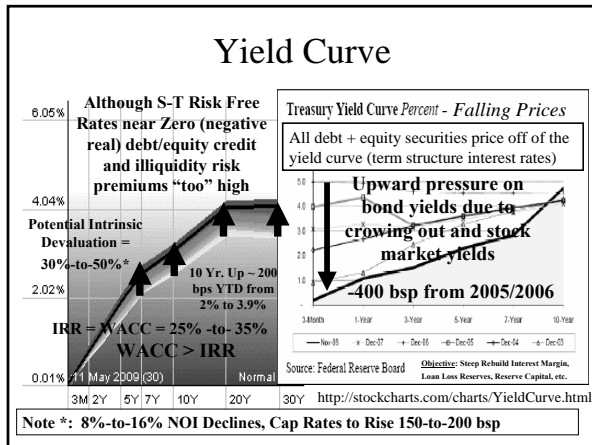
The Importance of IT Industries

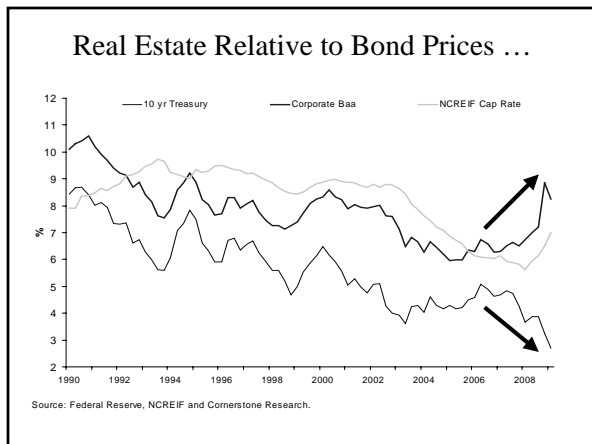


Silicon Valley Geography









Conclusions

Economic Risks

Market-Economic Risks:

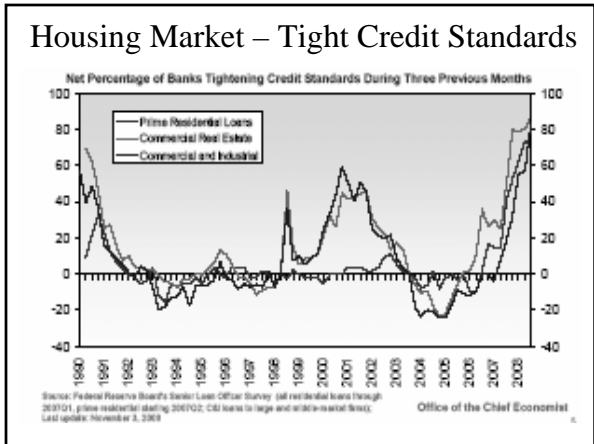
- High costs of living and doing business
- State-Local regulations, taxes, workers comp, deficits
- Lack of affordable/developable land and housing
- Traffic congestion and infrastructure constraints
- Out sourcing and migration
- Cut-backs in education and social services
- Mergers-consolidation industrial, technology, telecommunications and financial institutions

Macro-Economic Risks

- Middle East (Oil Price Spikes)
- Current Account and Budget Deficits (Interest Rates)
- Rising Inflation Expectations (Health Care/Food Costs)
- High-Rising Credit-Equity Risk Premiums (Spreads)
- Consumer-Business Confidence Investment
- Slow Global Growth and Protectionist Trade Policy
- Rising Loan (Credit) Defaults and (Mtg) Foreclosures
- Labor Strikes, Low Wage Growth, Underemployment
- Stock Option Back-Dating, Other Accounting Announcements Irregularities, Investor Confidence



Appendix



Commercial Real Estate Markets

- SF Office Rents down 24% -to- 35%, most since 2001
- SF Office Vacancy Rate 13% -to-18% (Colliers Inter.)
 - 1.1 million SF vacated since Jan 2008
 - 6 million SF up for renewal
 - PG&E 80,000 sf (123 Mission Street)
 - Charles Schwab (2Q09)
 - Macy's 500,000 sf
- 75% Class A office buildings downtown sold past 4 yrs
 - Buildings in Default (Real Capital Analytics):
 - 2135 Market (Lembi – One of 29)
 - 2712 Mission (Trustees Sale)
 - Potential Default: Broadway Partners (Citicorp Center, Once Sansome, 100 Cal., 50 Beale), 333 Bush (Hines/Sterling American Prop)

Lawrence Souza (lsouza@JohnsonSouzaGroup.com) brings to Johnson Souza Group, Inc. (Direct: (415-713-0213) over 20 years of experience in real estate economic and financial research. As Managing Director-Index Services, Charles Schwab Investment Management (CSIM); Chief Real Estate Economist and Director of Index Services, Global Real Analytics (GRA); Director of Research for BRE Properties, Inc. (REIT) in San Francisco and holding Senior Market/Research Analyst positions at Metric Institutional Realty Advisors and Mellon-McMahan/MacFarlane Realty Advisors, and market research positions at Norris, Beggs and Simpson and Grubb & Ellis commercial brokerage. Mr. Souza combines traditional fundamental real estate economic and market research with fundamental and technical financial and capital market research. This combined approach allows for the tracking and forecasting of economic, real estate and financial cycles and efficient portfolio construction, optimization and risk management.

Mr. Souza is also a licensed California Real Estate Broker (Realtor), specializing in urban-infill residential, commercial property transactions, and 1031 Exchanges in the San Francisco Bay Area and Western Region.

Mr. Souza has undergraduate degrees in Economics (BA) and Business Administration (BS) with concentrations in Accounting, Finance, Banking and Real Estate; and holds master's degrees in Applied Economics (MA), Finance/Investments (MS), Public Administration (MPA), and Information Systems (MSIS). Mr. Souza has been teaching Modern Real Estate Principles and Finance since 1996 with an emphasis on real estate in a modern portfolio and capital markets context; and the institutionalization, securitization, internationalization and technologization of real estate markets and products.
