

SF Bay Area Economic Trends and Commercial Real Estate Investment Analysis 2008 - 2009

Prepared for

www.GlobalExpo.us

Prepared by

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Golden Gate University**



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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Introduction

- Introduction
- Business/Commercial Real Estate Cycles
- Commercial Market Fundamentals
- Employment
- Technology/Venture Capital Trends
- Interest Rates and Inflation
- Residential Market
- Conclusions: Advantages and Risks

Introduction

SF Bay Area

Business-Market Cycle Overview

- Economy in decline/trough phase, employment contraction accelerating: 36-to-60 month trough.
- Economic contraction to bottom 2Q/3Q 2009.
- Commercial construction cycle peak 2002, trough in 2004-2005, growth phase from 2006 through 2007: low no new construction.
- Next business cycle peak 2015 - 2020, next technology-employment cycle peak 2016 – 2018, along with rent spikes.
- Target markets for commercial investment 2009-2010:

Downtown San Francisco and Oakland, I-680/Fremont Corridors, Downtown San Jose, SF Peninsula, Marin and Santa Cruz Counties

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:

- Biological/Physiological/Psychological
- Philosophical Systems
- Legal Systems
- Political Systems
- Economic Systems
- Financial Systems

Institutional Deconstruction

- **Loss of Civil Liberties and Personal/Individual 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, Et.Al.

Institutional Reconstruction

- **Gain of Civil Liberties and Personal/Individual Rights**
- **Improved Governmental Transparency and Accountability**
- **Assemble Social Welfare State and Safety Net**
- **Public Input into Policy Development by Special Interests**
- **Redistribution and Concentration of Wealth (Public Goods)**
- **Improved Access to Democratic Institutions and Legal System**
- **Freedom of Speech and Press (Eliminate Censorship)**
- **Separation of Church and State, Acceptance of Science**

“Institutional construction is the building of pluralistic and democratic institutions by public interests within society. The goal is to “construct” institutions as representative institutions that enforce and redistribute public property rights to the majority, at average total cost, to raise overall social and economic welfare.”

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.

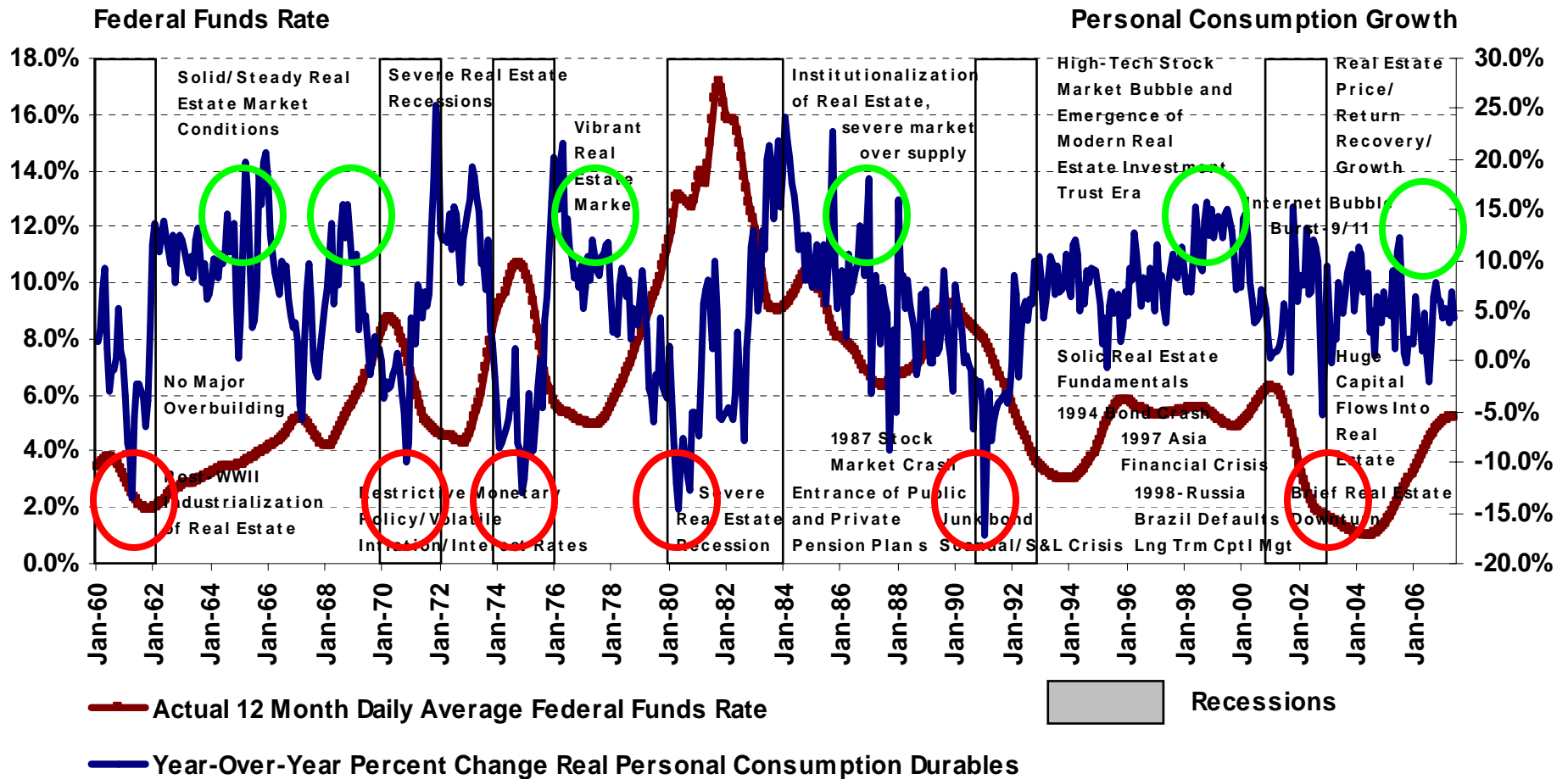
US Budget Deficits

- **\$11 trillion public debt outstanding, \$55 billion in interest; Total Debt-to-GDP to reach ~100% by 2015.**
 - \$1.2 trillion annual budget deficit, not including \$600 billion for Iraq War 2004 – 2009; defense budget up 41% since 2001
 - Administration to cut deficit in half by 2009, over optimistic assumptions for rising tax revenue, excluding cost of Iraq/Afghanistan wars (\$100 + billion in 2008)
 - After 2005, will have to pay \$1.5 trillion for permanent tax cuts and \$700 billion for Medicare prescription drug program
 - Budget deficits to total \$10 trillion over next 10 years
 - Foreigners currently own 47% of U.S. government debt (China/Japan)

Business and Commercial Real Estate Cycles

Business Cycle Theory

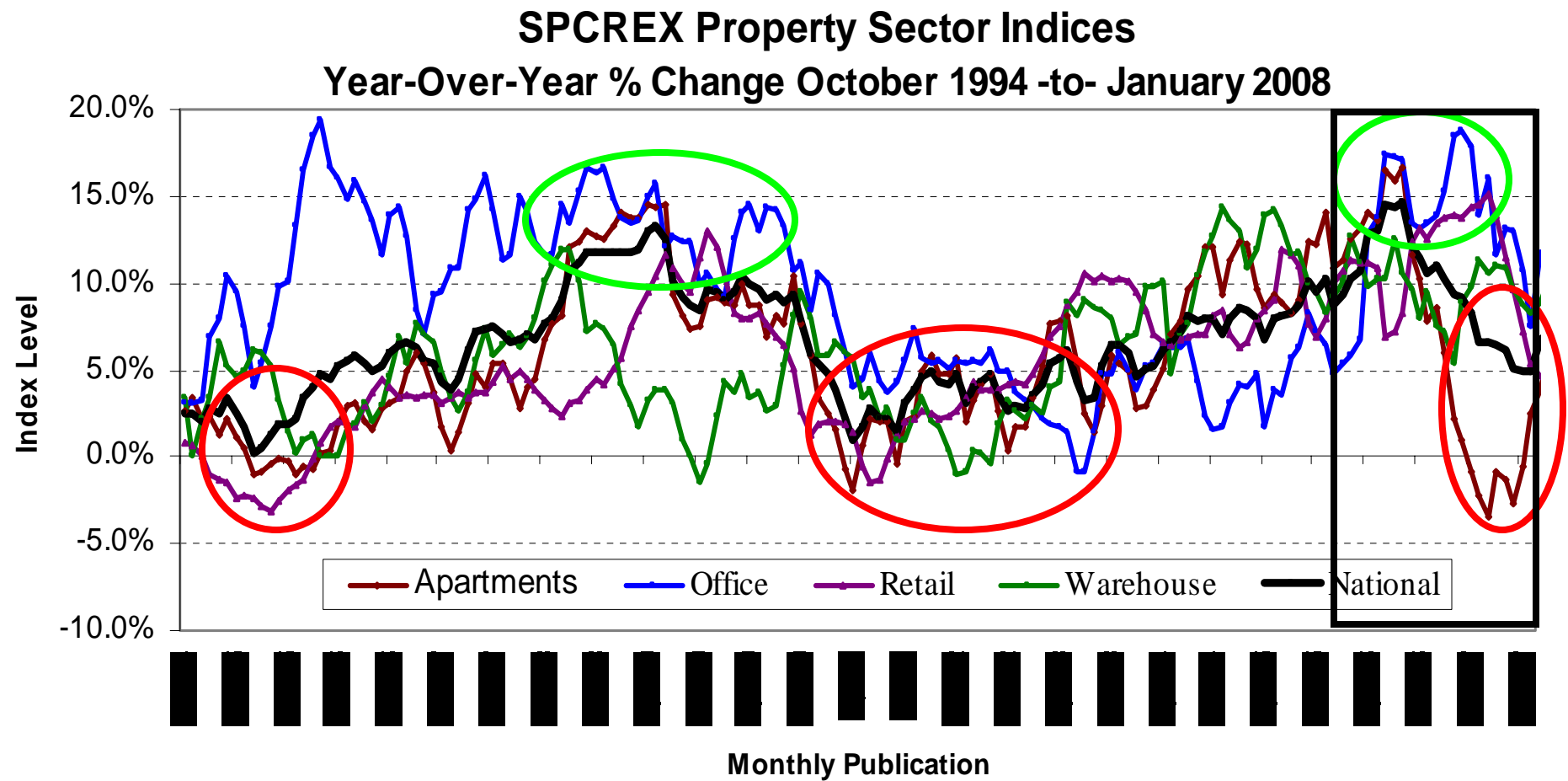
CONSUMPTION VS. INTEREST RATE CYCLES



Sources: Board of Governors of the Federal Reserve System and U.S. Department of Commerce: Bureau of Economic Analysis.

Commercial Real Estate Cycles

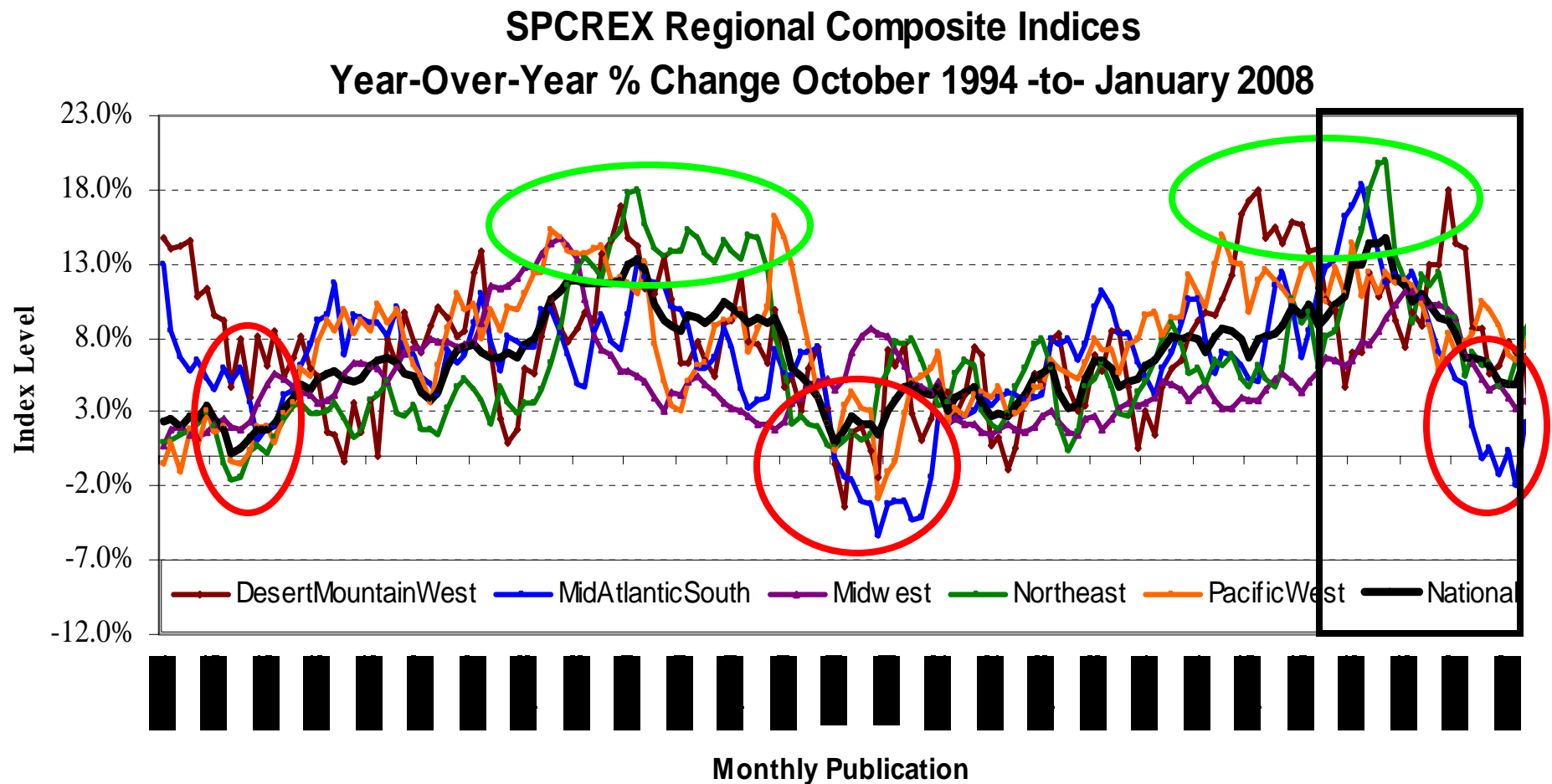
SPCREX™ Property Sector Performance



www.spcrex.standardandpoors.com

Commercial Real Estate Cycles

SPCREX™ Regional Composite Performance



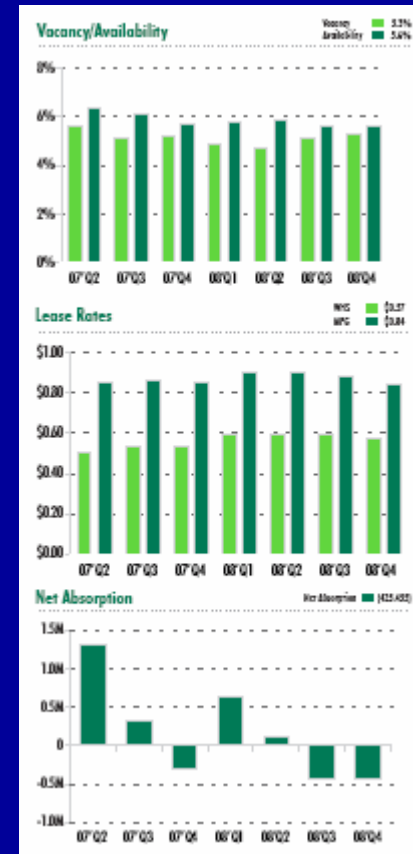
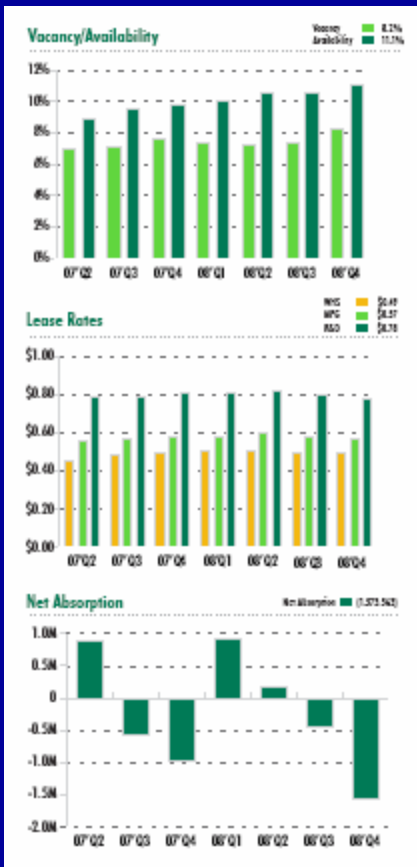
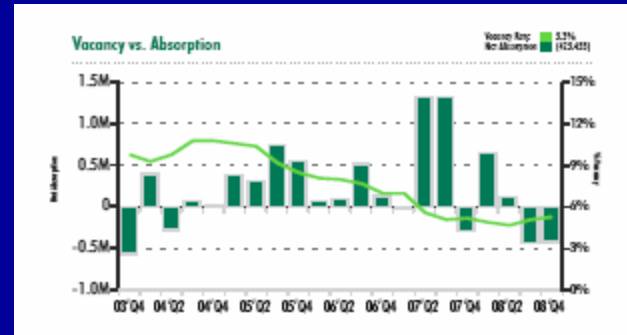
www.spcrex.standardandpoors.com

Commercial Market Fundamentals

Oakland Industrial



Silicon Valley Industrial



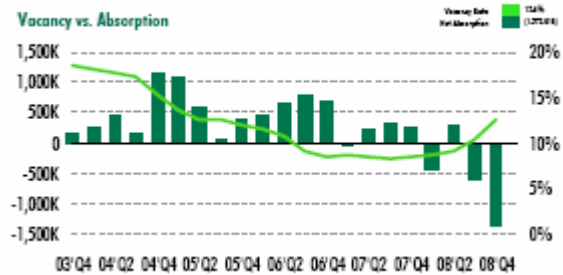
Source: CBRE Market Research Reports.

San Francisco Office

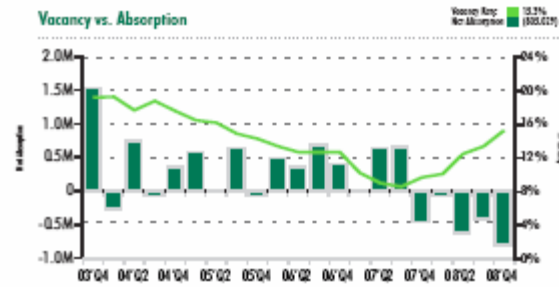
Silicon Valley Office

Oakland Office

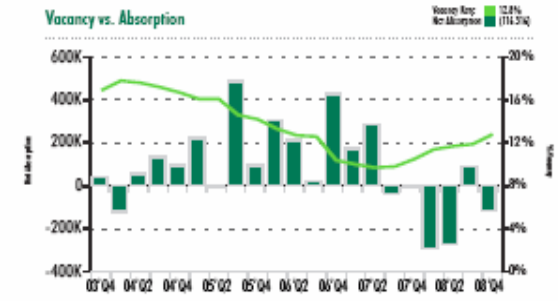
Vacancy vs. Absorption



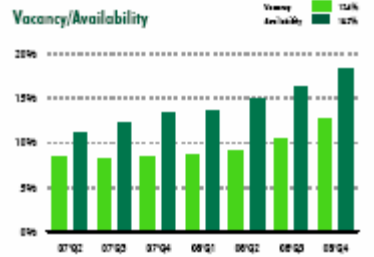
Vacancy vs. Absorption



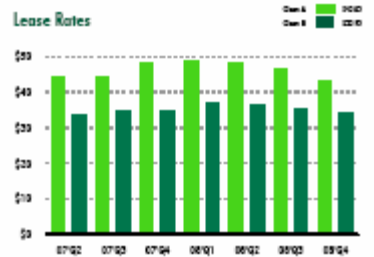
Vacancy vs. Absorption



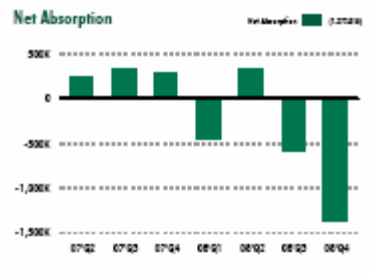
Vacancy/Availability



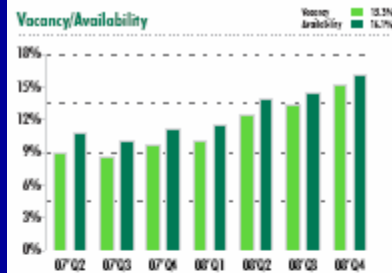
Lease Rates



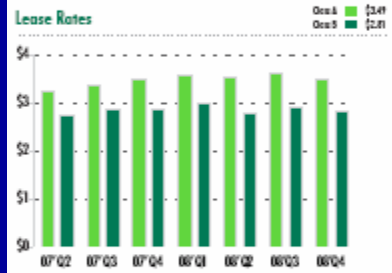
Net Absorption



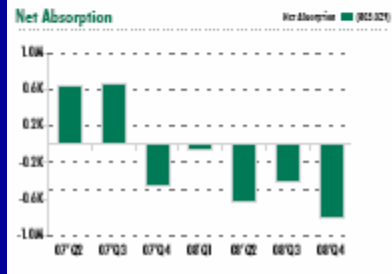
Vacancy/Availability



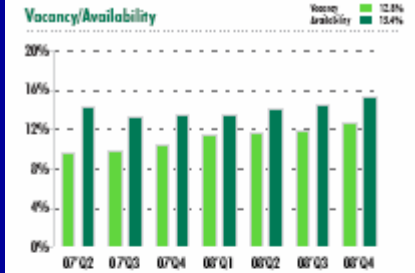
Lease Rates



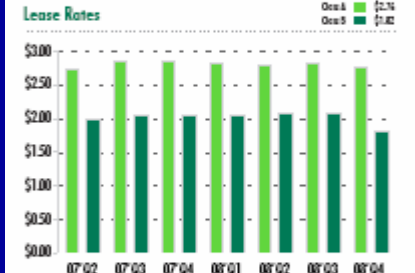
Net Absorption



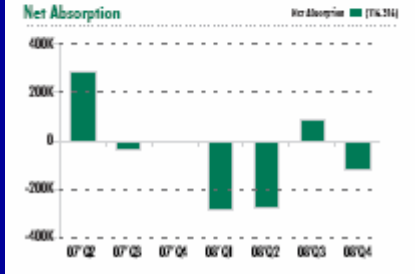
Vacancy/Availability



Lease Rates



Net Absorption

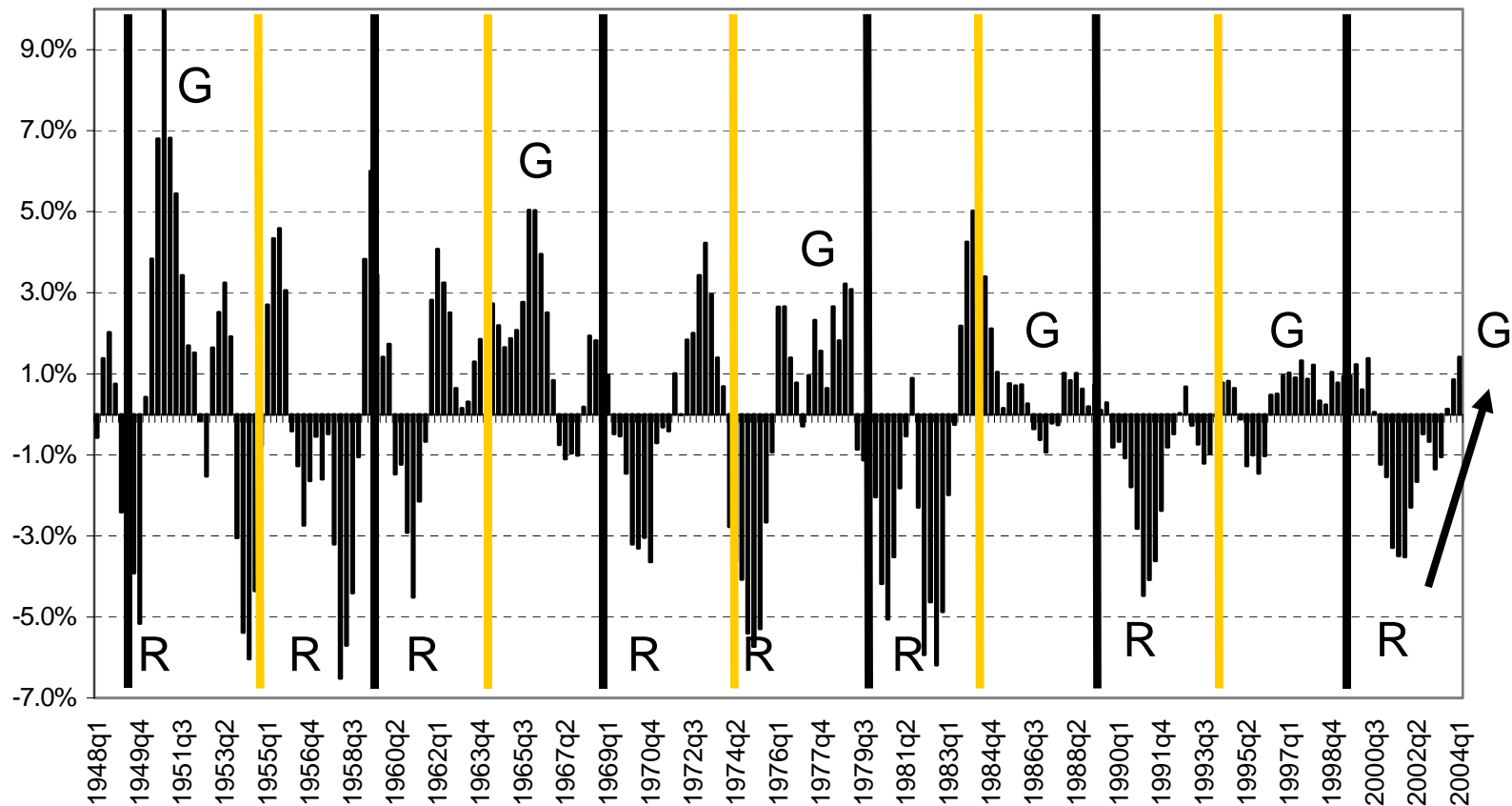


Source: CBRE Market Research Reports.

Production and Employment

United States Business Cycles

UNITED STATES BUSINESS CYCLES (1948 - 2004)



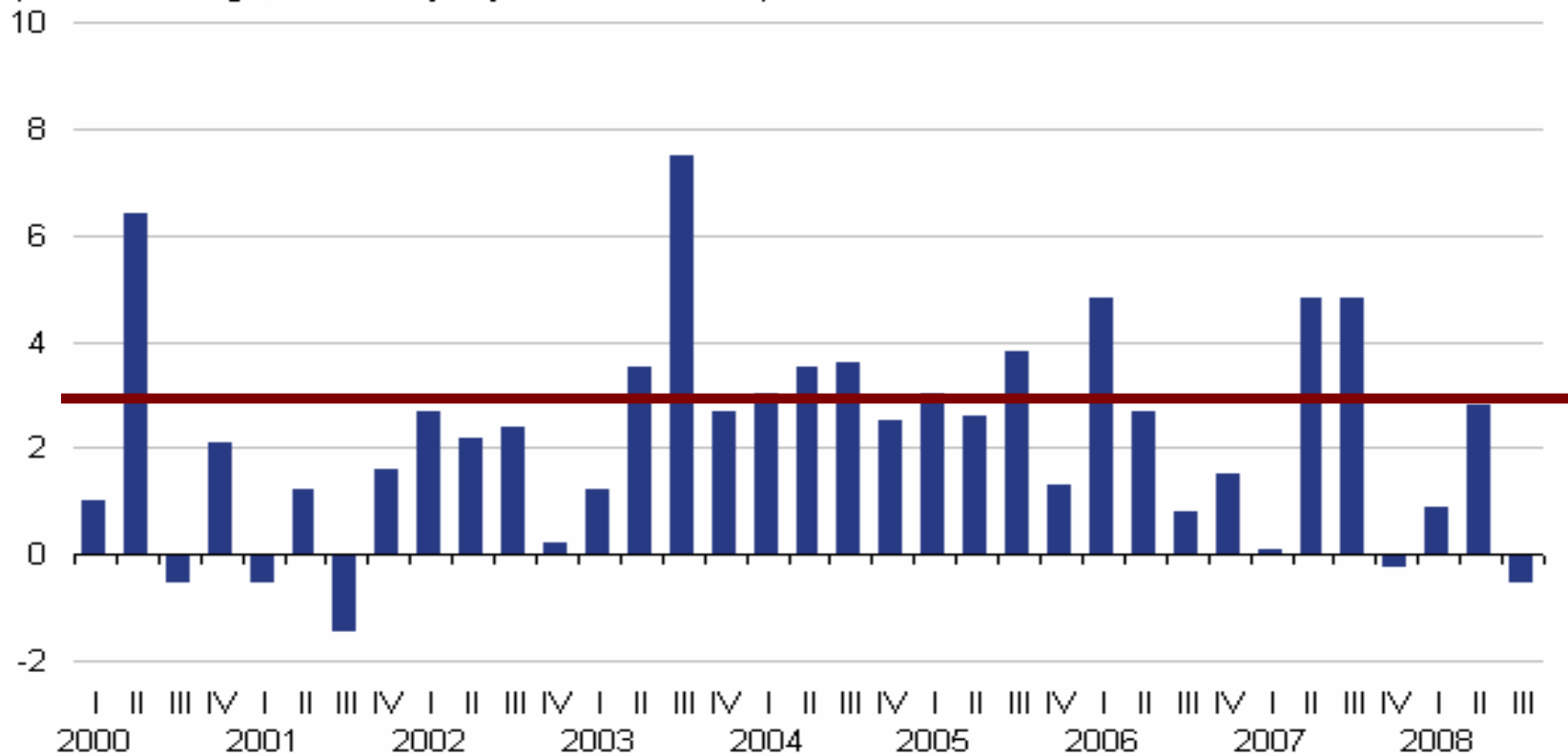
Source: Bureau of Economic Analysis and Johnson/Souza Group, Inc.

<http://www.bea.doc.gov/bea/dn/home/gdp.htm>

Gross National Product (GDP)

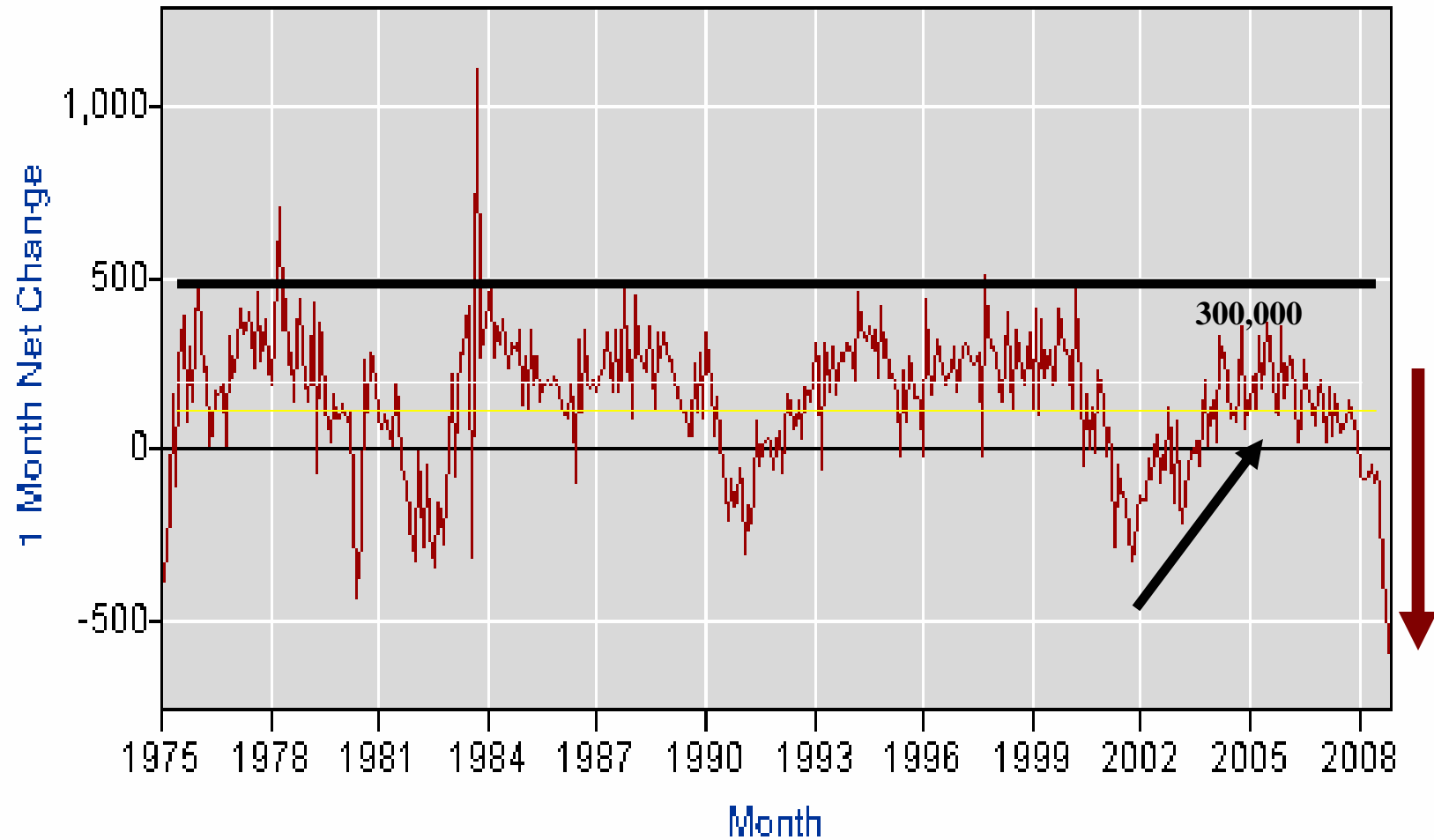
Real Gross Domestic Product

(Percent change, seasonally adjusted annual rate)



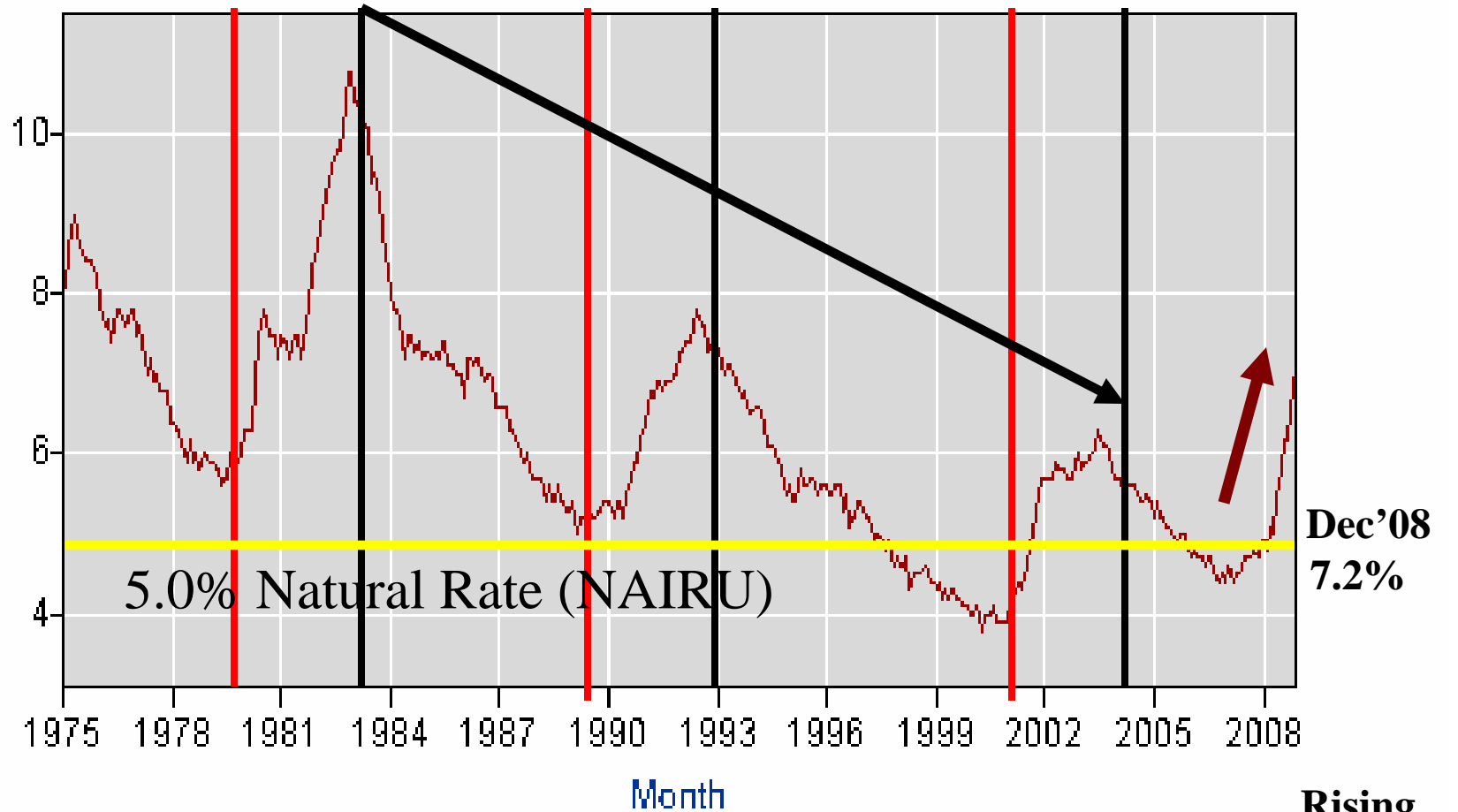
U.S. Bureau of Economic Analysis

Payroll Employment



Source: Bureau of Labor Statistics.
<http://www.bls.gov>

U.S. Unemployment Rate

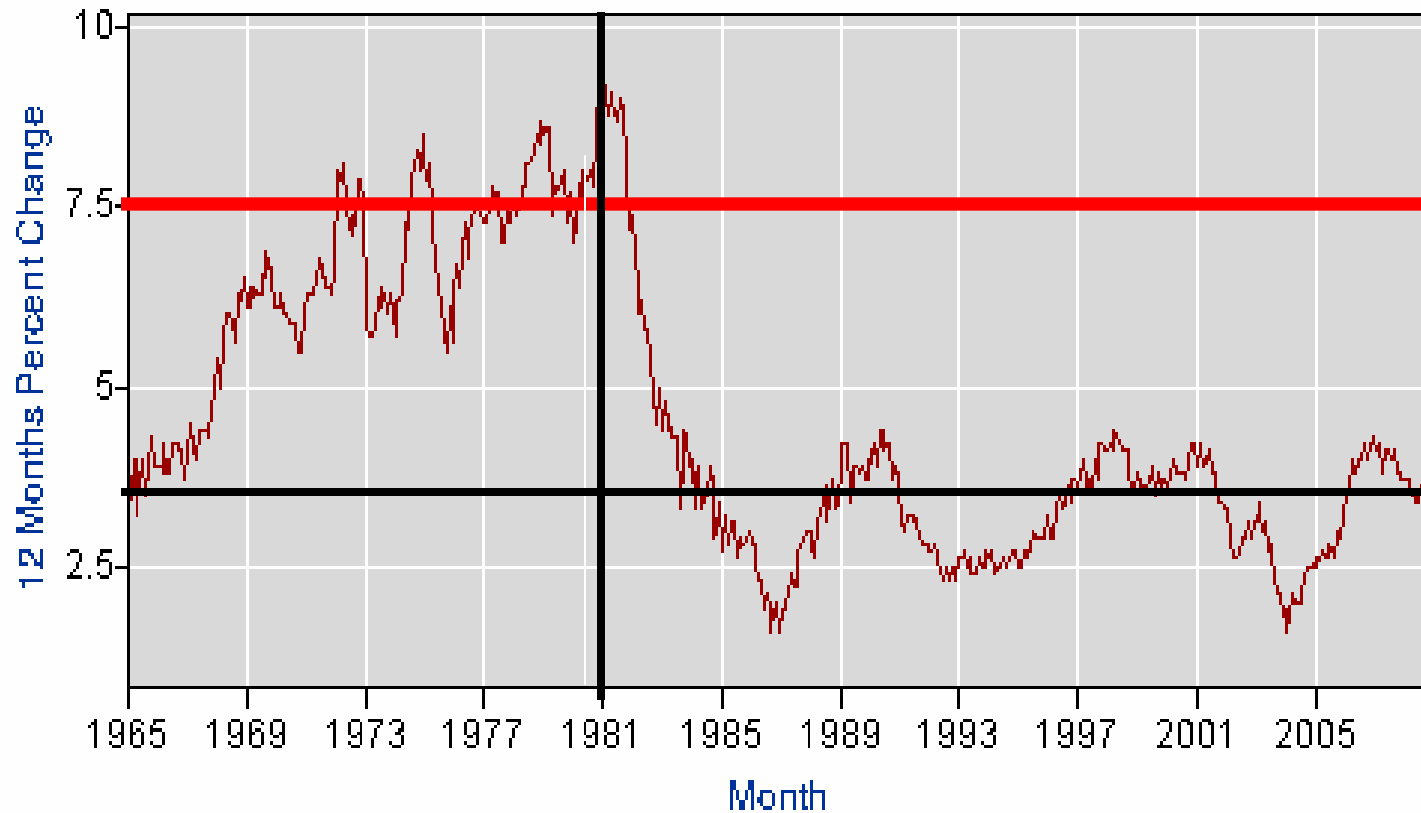


Source: Bureau of Labor Statistics.

Rising
from 5 Yr
Lows

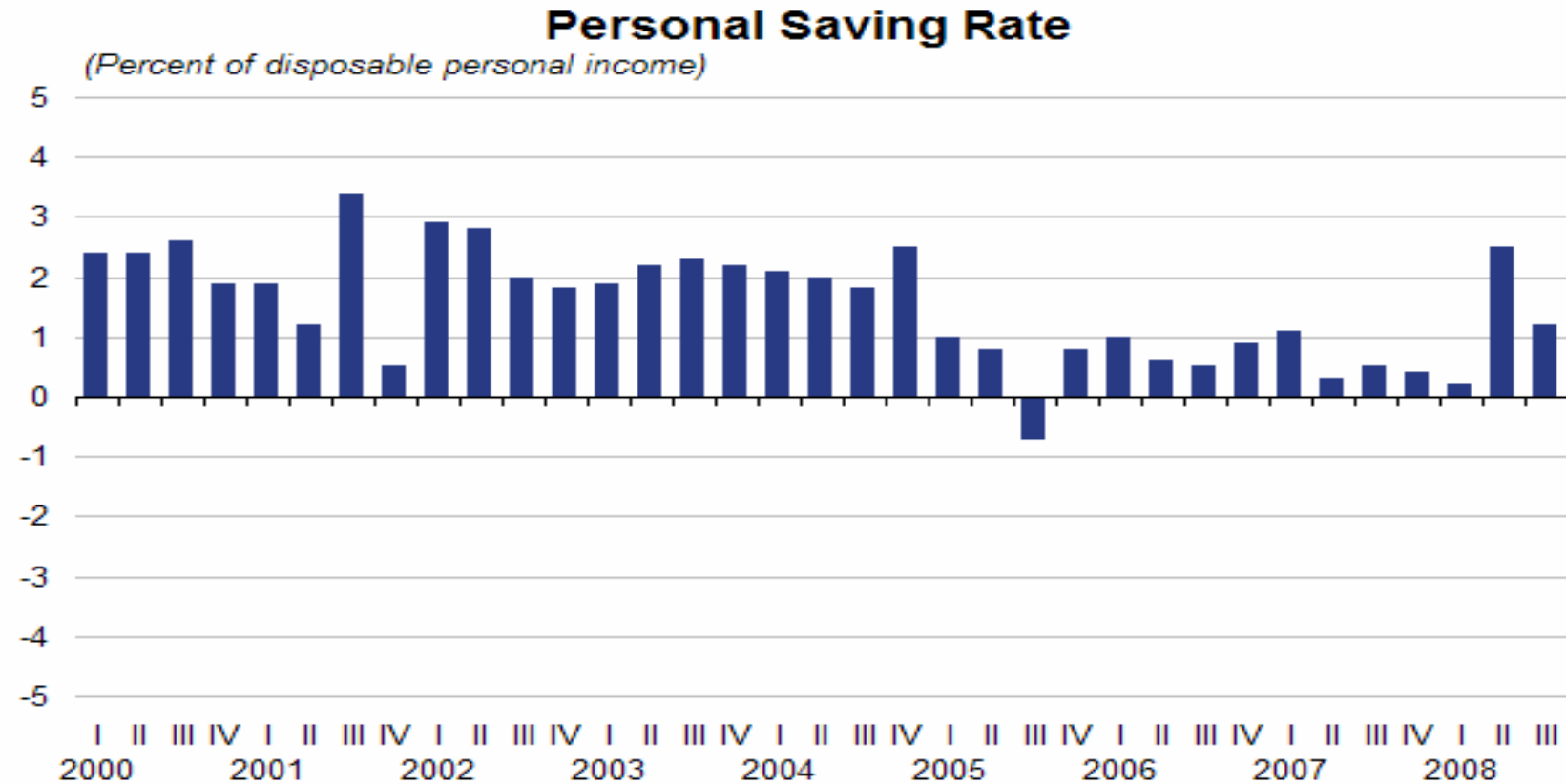
Income and Wages

Average Hourly Earnings of Production Workers



Source: Bureau of Labor Statistics. <http://www.bls.gov>

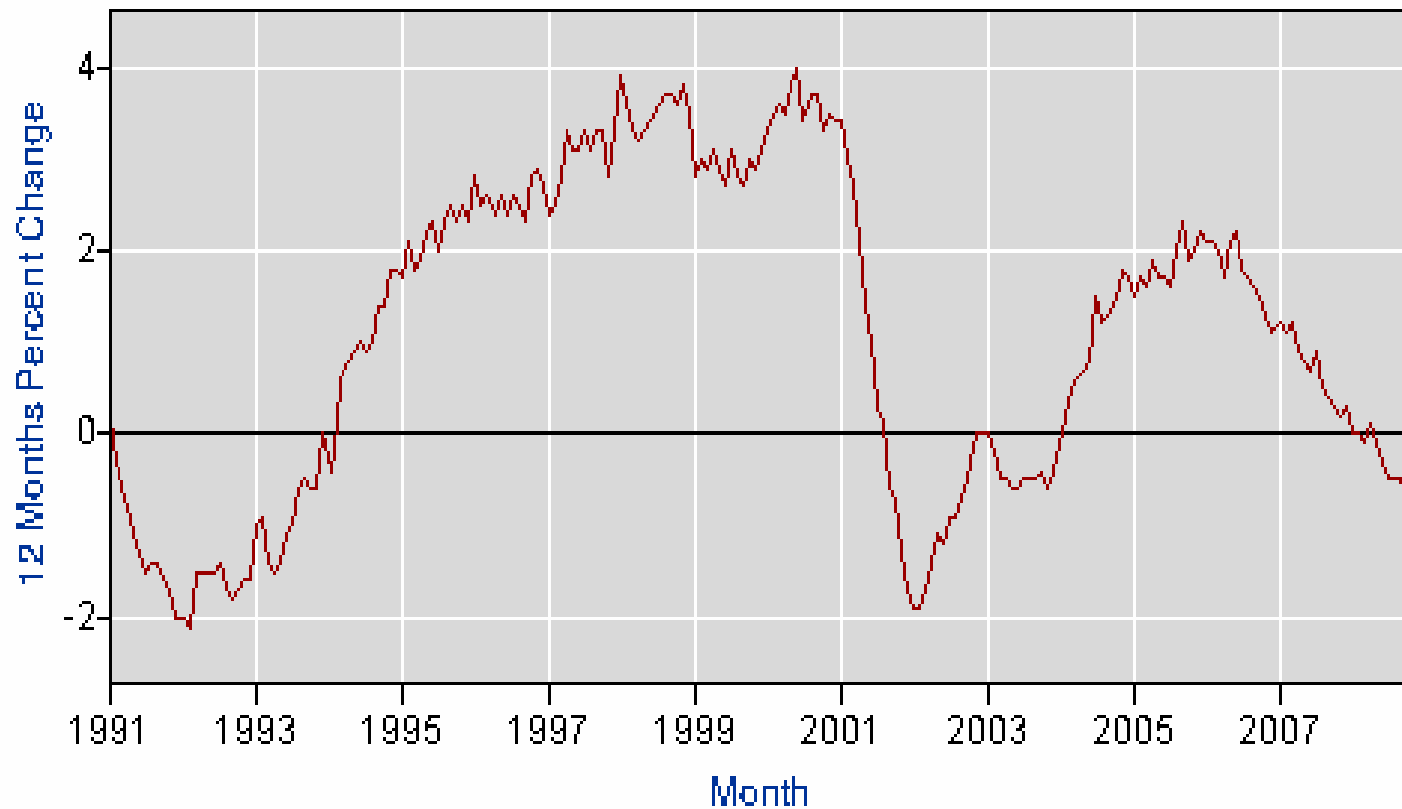
Personal Savings Rate



U.S. Bureau of Economic Analysis

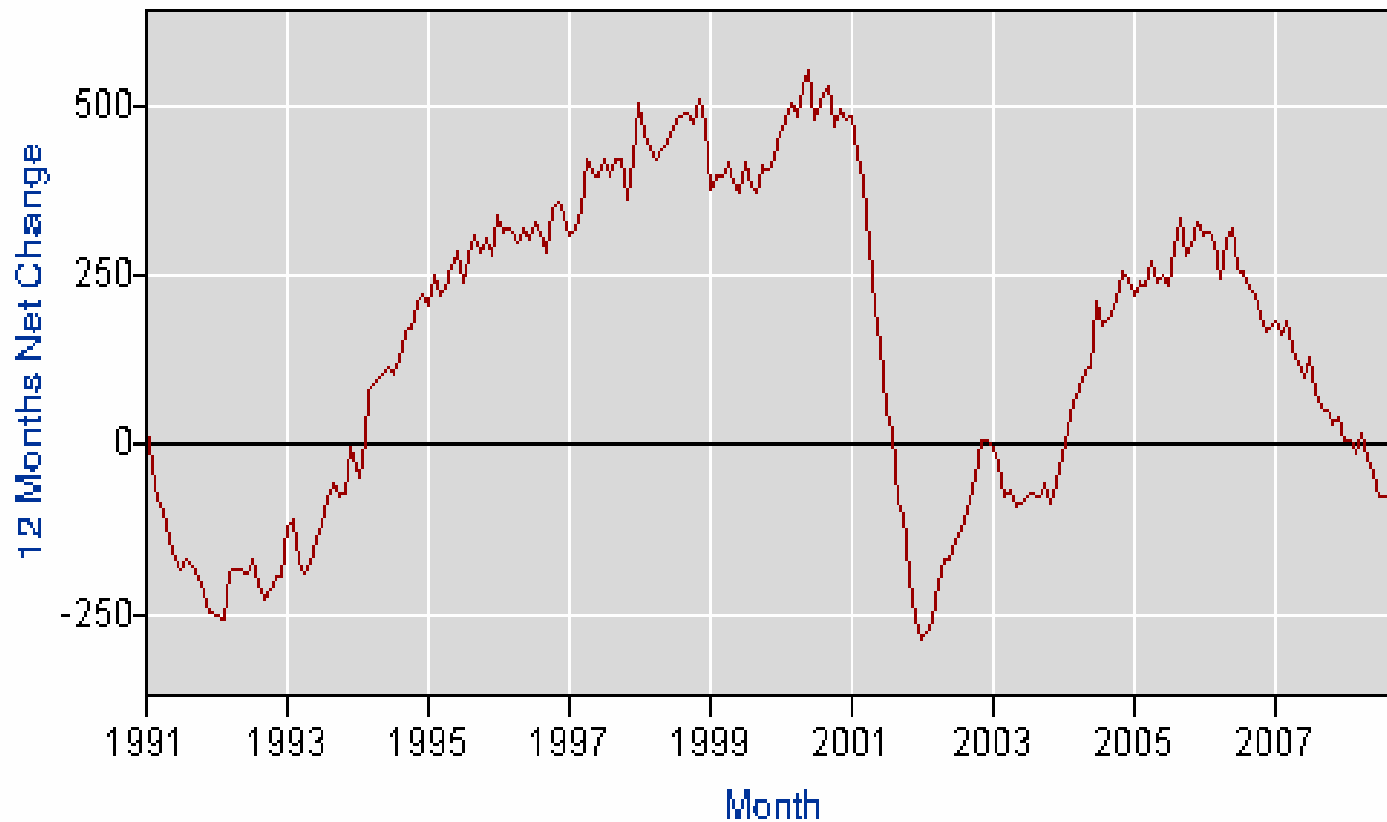
Source: Bureau of Economic Analysis. <http://www.bea.gov/briefrm/saving.htm>

California Employment Growth (% YOY)



Source: Bureau of Labor Statistics.

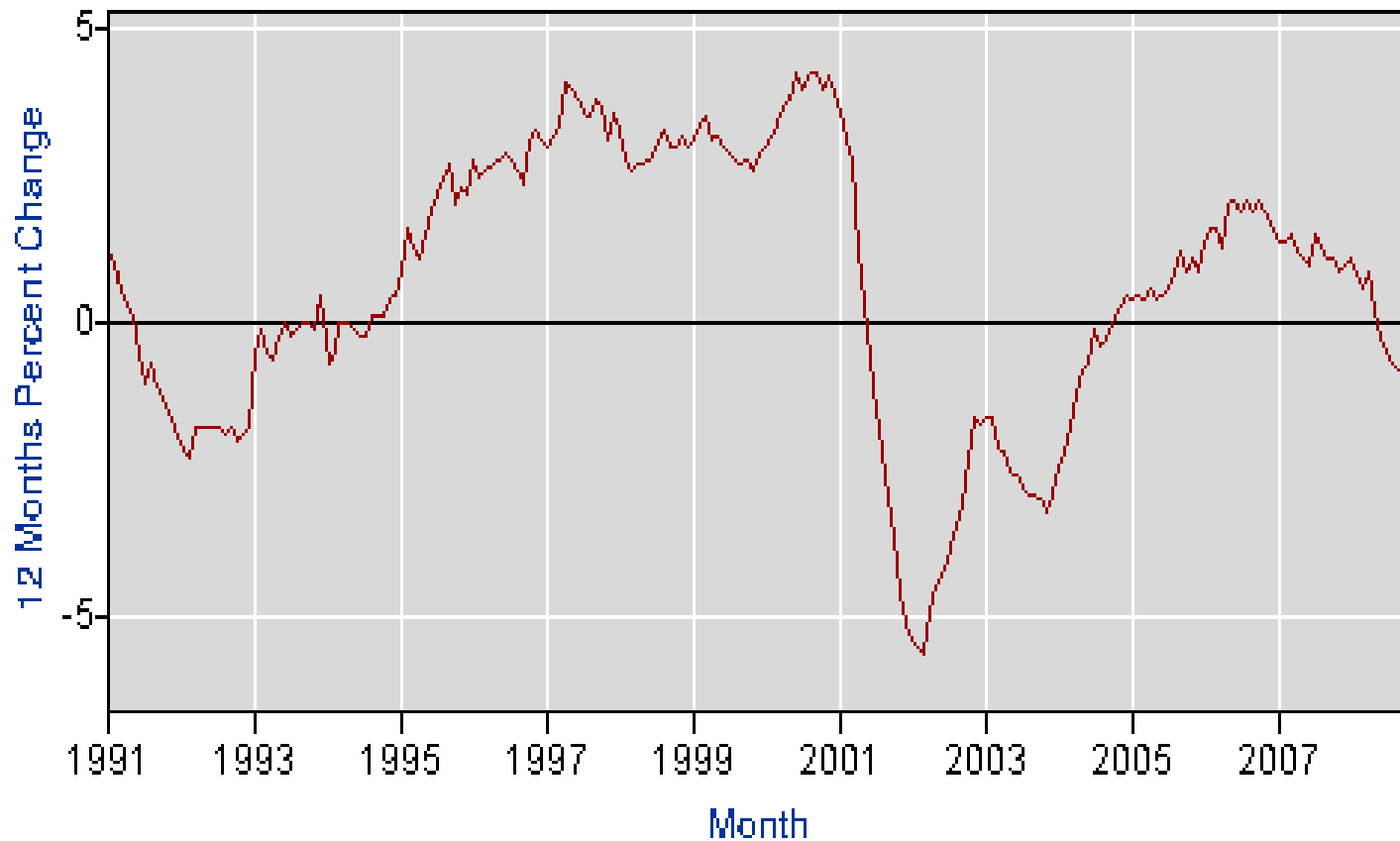
California Employment Growth (#YOY)



Source: Bureau of Labor Statistics.

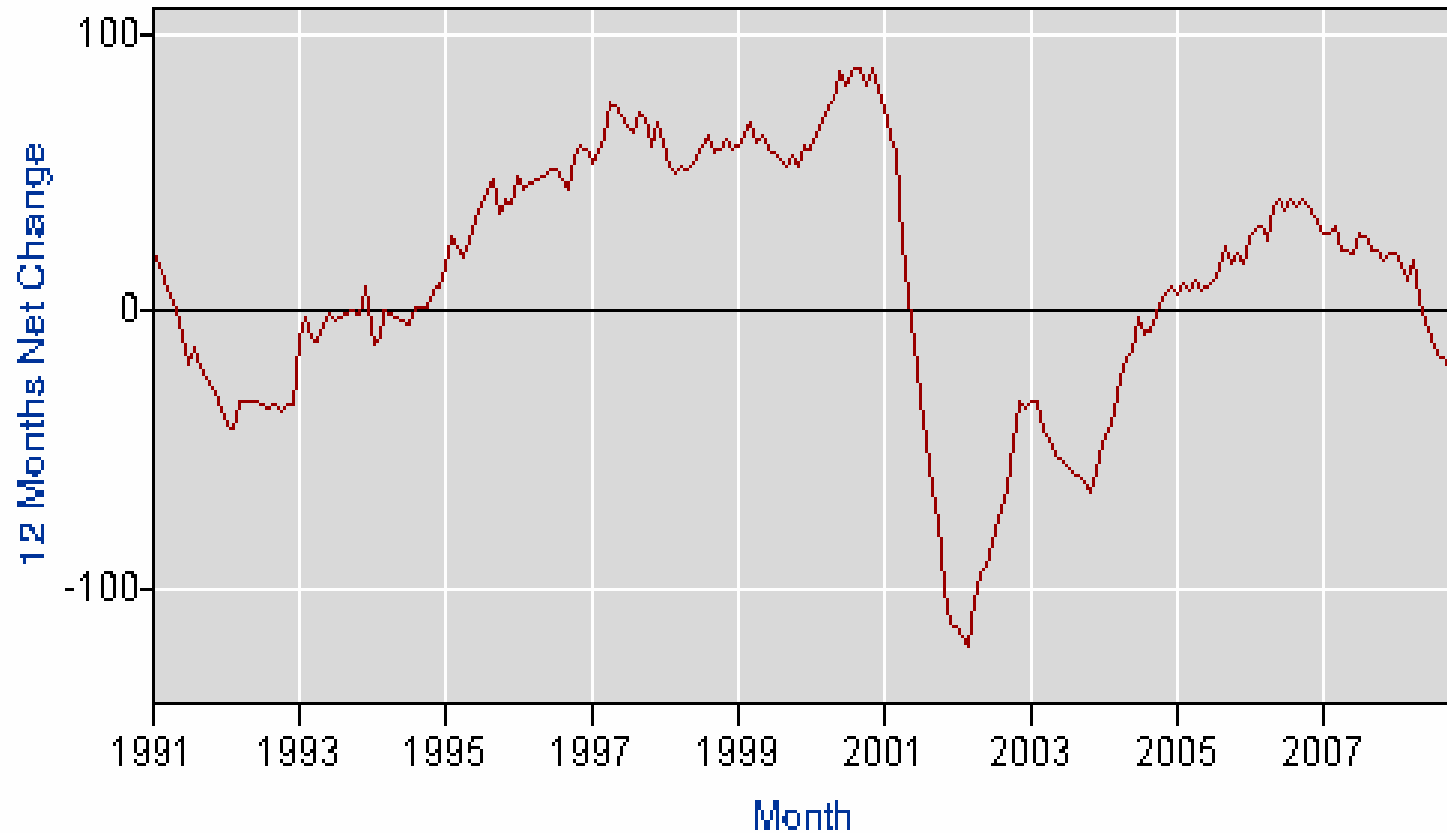
San Francisco-Oakland-Fremont, CA

Monthly % Year-Over-Year Non-Farm Employment Growth Rates

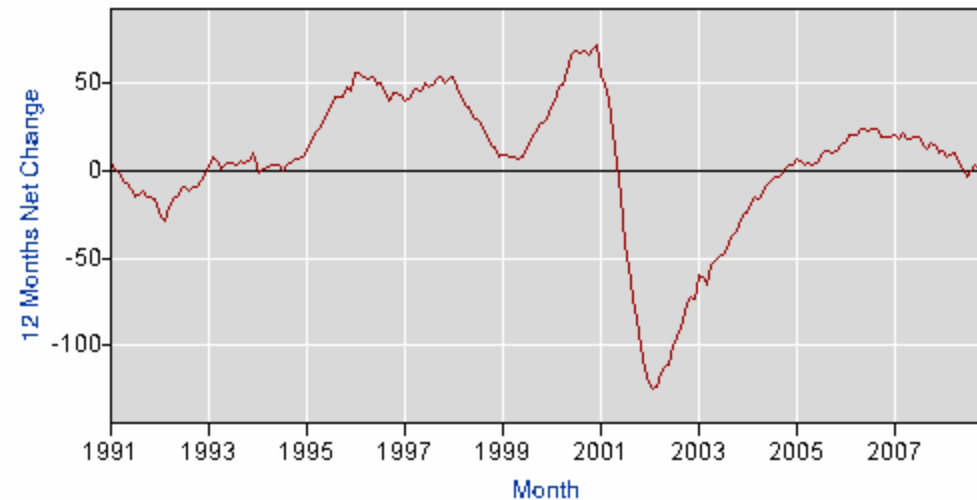
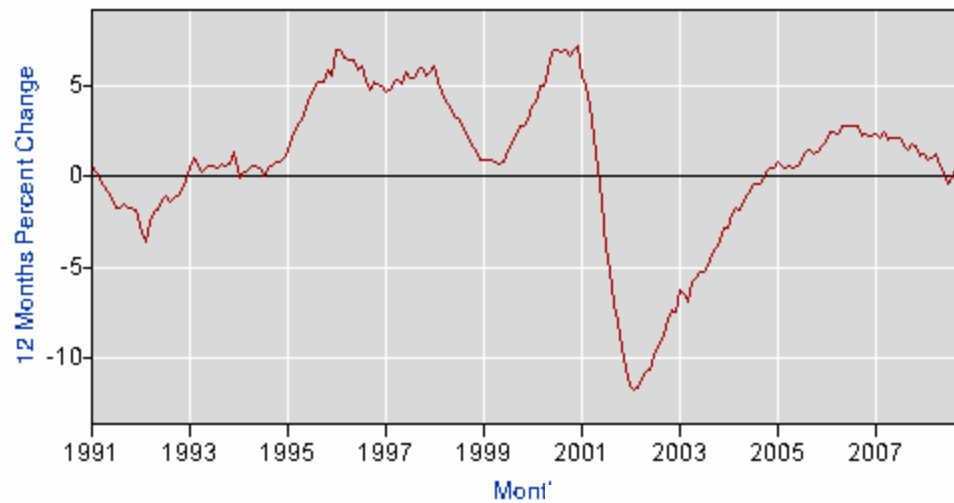


San Francisco-Oakland-Fremont, CA

Monthly # Year-Over-Year Non-Farm Employment Growth Rates

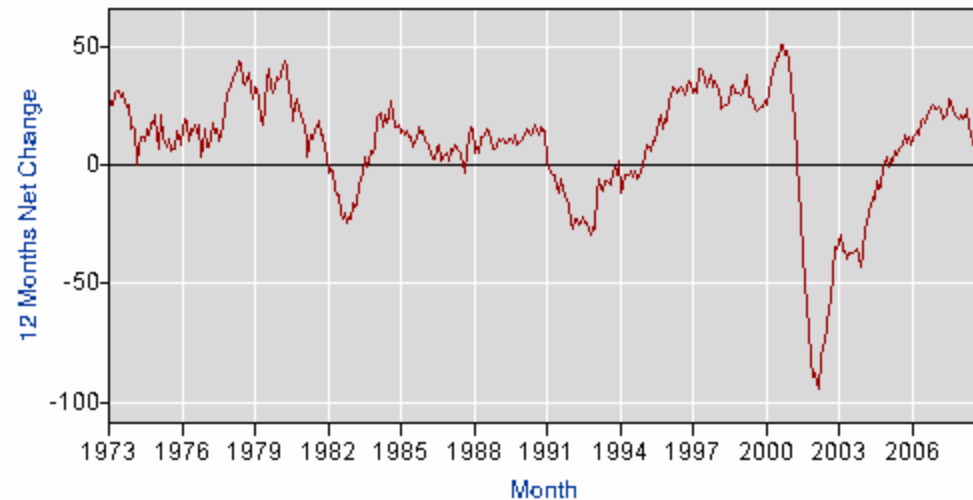
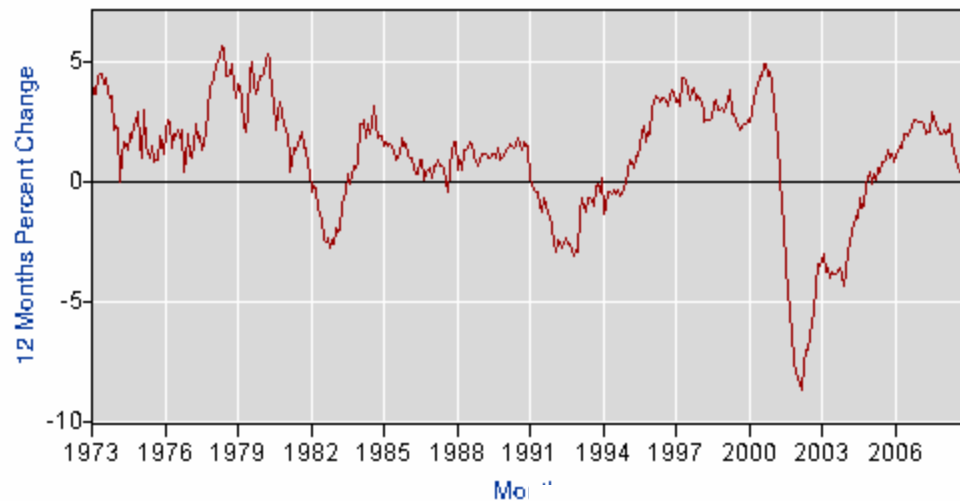


San Jose PMSA Non-Farm Employment Growth (YOY)



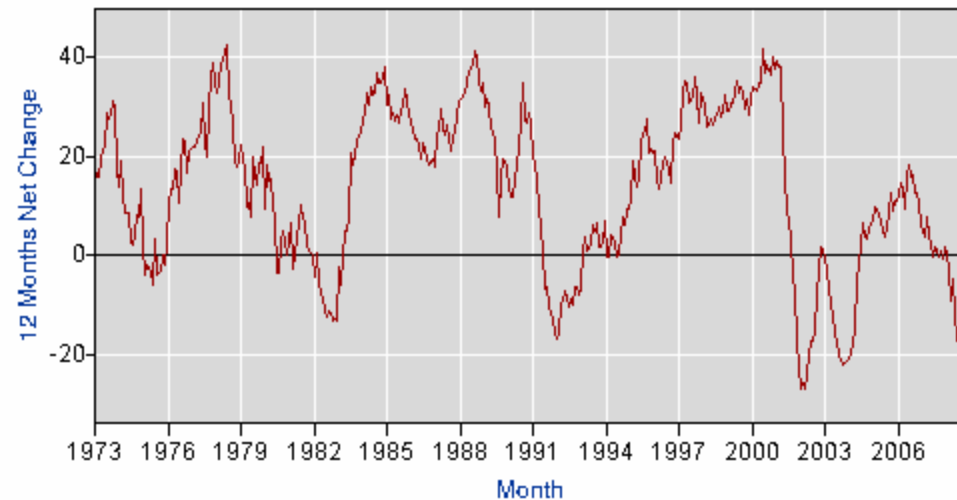
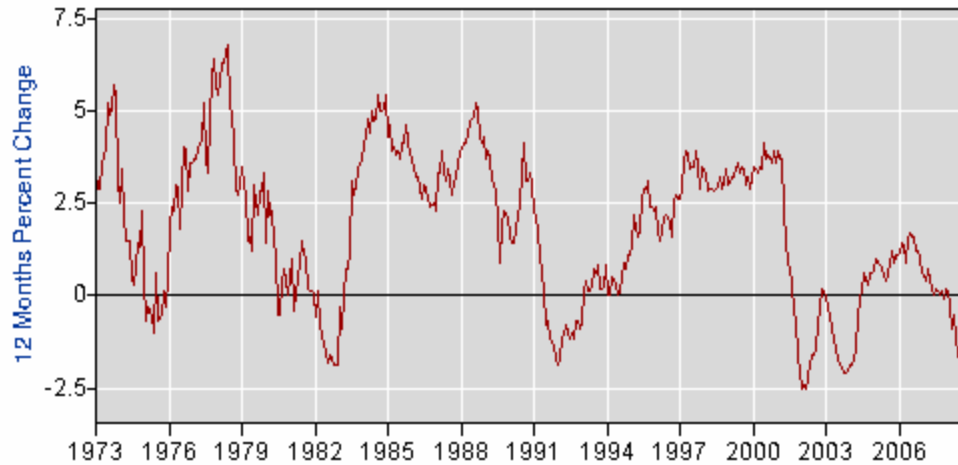
Source: Department of Labor Statistics.

San Francisco PMSA Non-Farm Employment Growth (YOY)



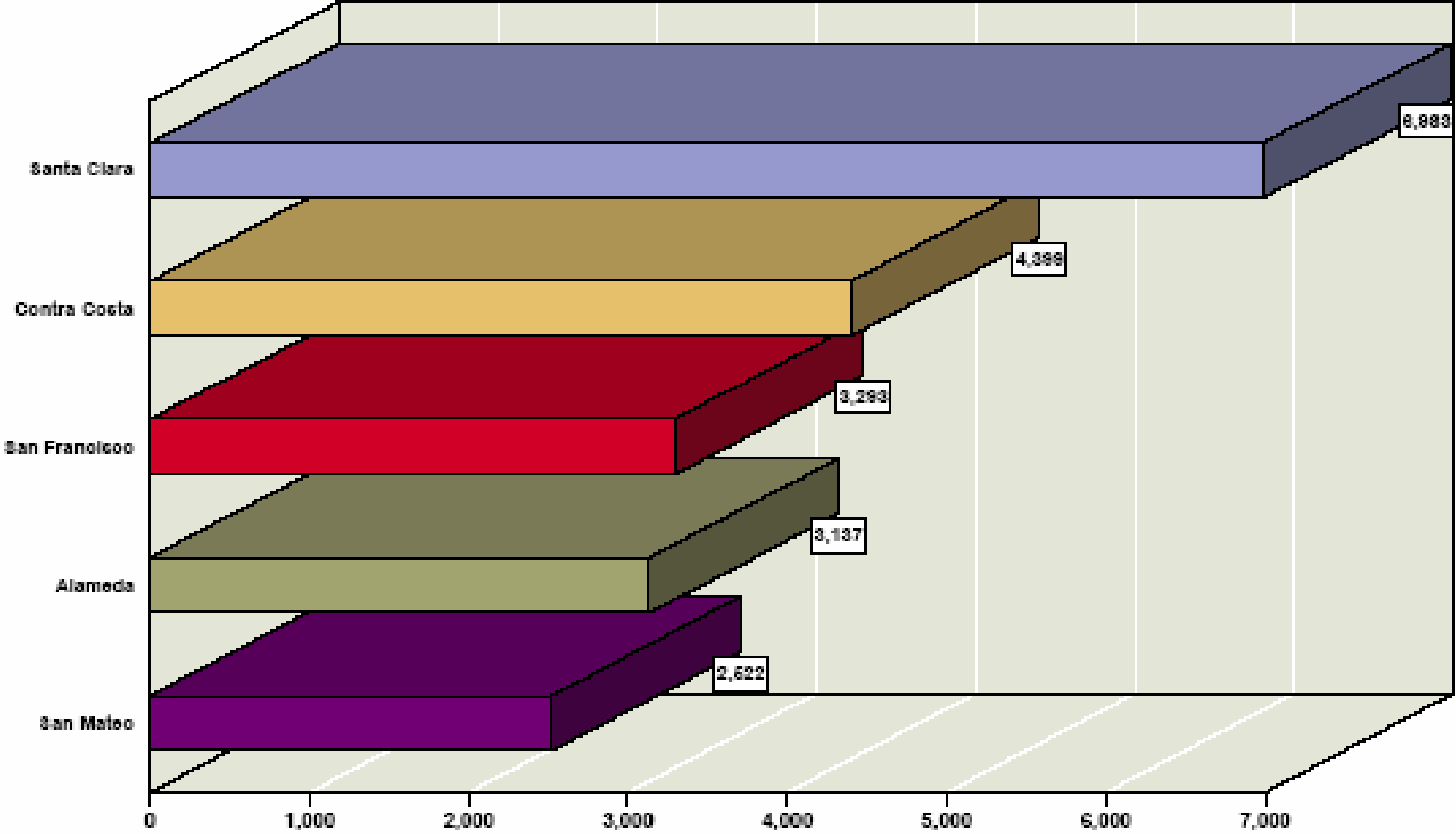
Source: Department of Labor Statistics.

Oakland PMSA Non-Farm Employment Growth (YOY)



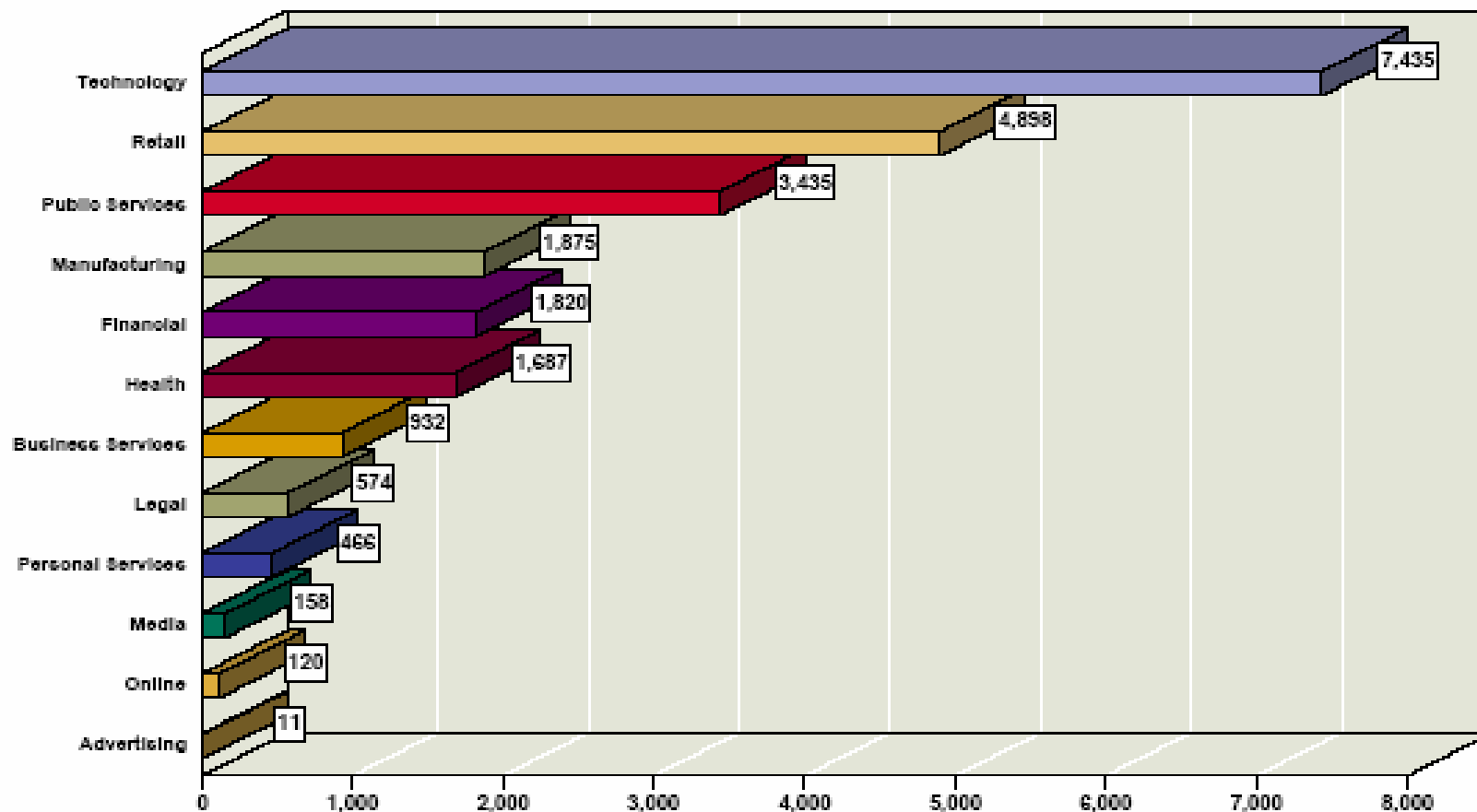
Source: Department of Labor Statistics.

of Employee Layoffs by County - Bay Area 2008



Source: EDD - Worker Adjustment and Retraining Notification (WARN)

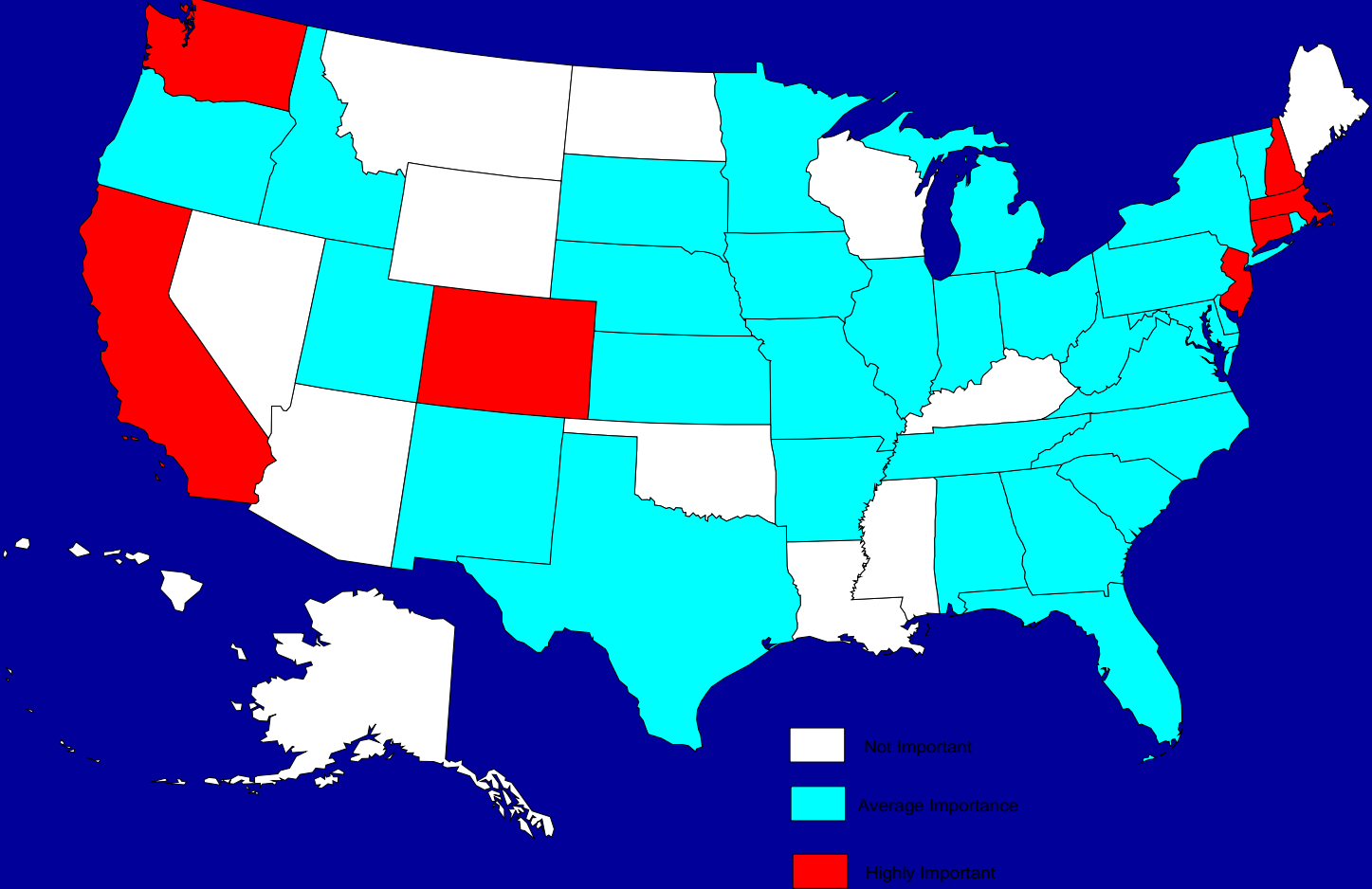
of Employee Layoffs by Industry - Bay Area 2008



Source: EDD - Worker Adjustment and Retraining Notification (WARN)

Technology/Venture Capital Trends

The Importance of IT Industries



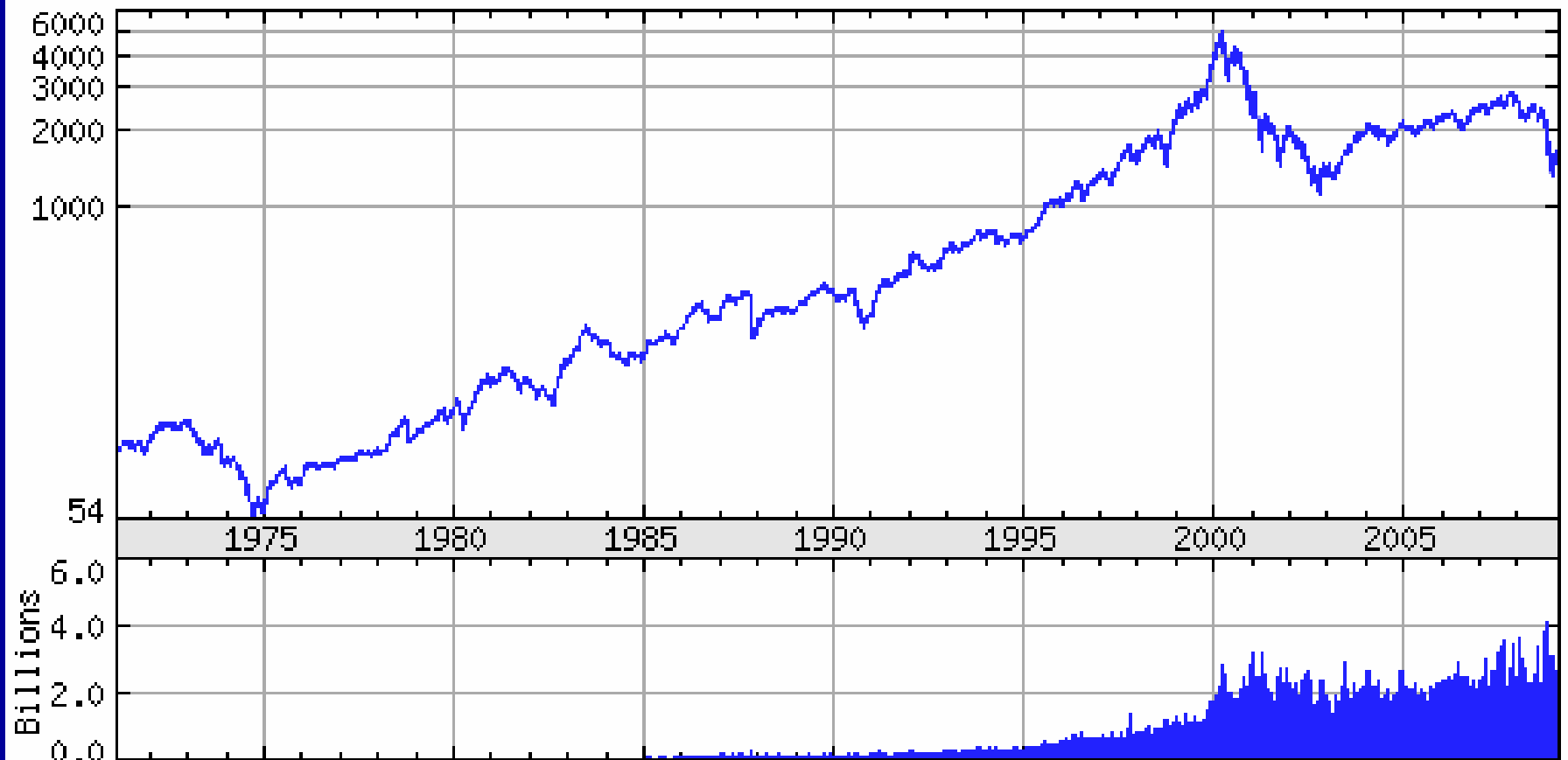
Note: IT accounts for 10.5% of U.S. Employment

Silicon Valley Geography



Technology

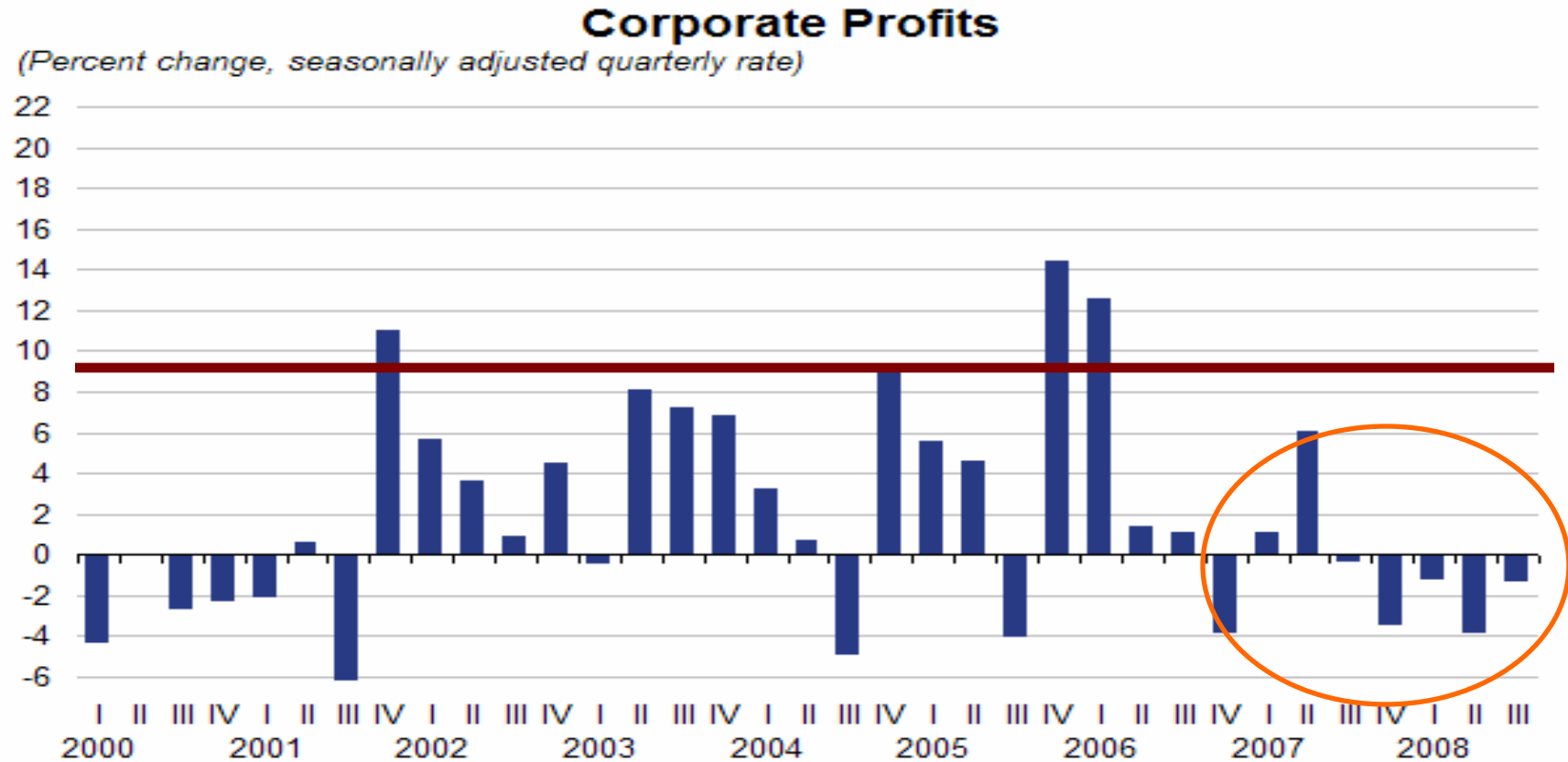
NAS/NMS COMPOSITE (NASDAQ STOCK)
as of 16-Jan-2009



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<http://finance.yahoo.com/>

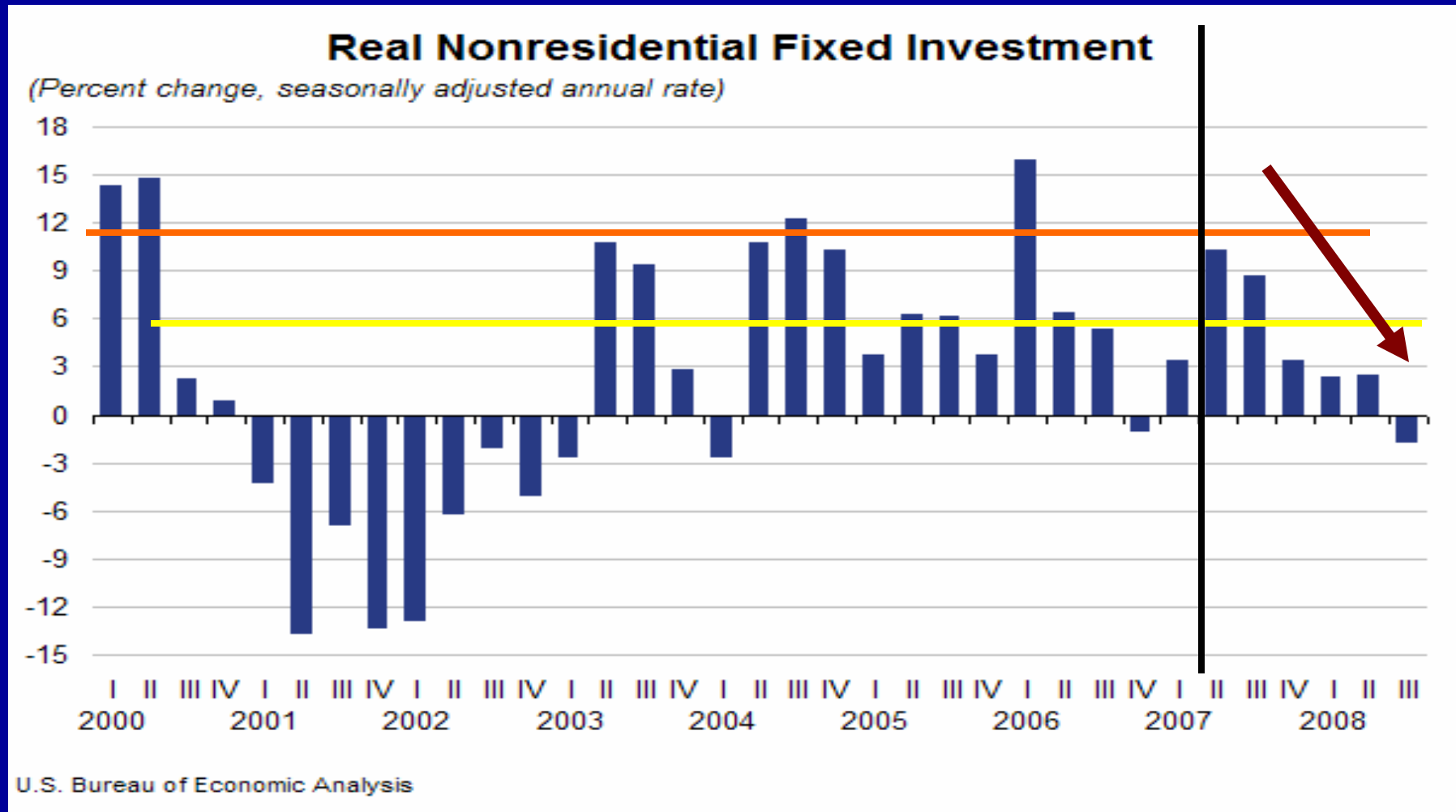
Corporate Profits



U.S. Bureau of Economic Analysis

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

Non-Residential Fixed Investment



Source: Bureau of Economic Analysis. <http://www.bea.gov/briefrm/nonresfi.htm>

Venture Capital Flows

Investments by Region / Q3 2008

Regions Defined	Total \$ Invested	Average \$ Per Deal	Deals
All	\$7,131,302,400	\$7,862,516	907

Region	Amount	% of Total	Deals
Silicon Valley	\$2773M	38.89%	292
New England	\$834M	11.70%	117
LA/Orange County	\$573M	8.03%	54
NY Metro	\$546M	7.66%	71
Midwest	\$395M	5.54%	60
Northwest	\$295M	4.14%	44
Texas	\$275M	3.86%	38
Philadelphia Metro	\$268M	3.76%	36
Southeast	\$250M	3.51%	51
North Central	\$235M	3.30%	19
Colorado	\$196M	2.75%	21
DC/Metroplex	\$181M	2.53%	44
San Diego	\$178M	2.50%	22
SouthWest	\$59M	0.83%	17
Upstate NY	\$32M	0.45%	5
Sacramento/N.Cal	\$21M	0.29%	6
AK/HI/PR	\$12M	0.17%	1
South Central	\$7M	0.10%	9

Source: Venture Economics. <http://www.ventureeconomics.com/vec/us.html>.

<https://www.pwcmoneytree.com/MTPublic/ns/index.jsp>

Venture Capital Flows

Investments by Industry / Q3 2008

Industries Defined	Total \$ Invested	Average \$ Per Deal	Deals
All	\$7,131,302,400	\$7,862,516	907

Industry	Amount	% of Total	Deals
Biotechnology	\$1350M	18.93%	114
Software	\$1343M	18.83%	214
Industrial/Energy	\$1191M	16.71%	96
Medical Devices and Equipment	\$896M	12.57%	93
Media and Entertainment	\$409M	5.74%	92
IT Services	\$403M	5.65%	62
Semiconductors	\$396M	5.55%	50
Telecommunications	\$323M	4.53%	45
Networking and Equipment	\$178M	2.50%	21
Financial Services	\$142M	1.99%	18
Electronics/Instrumentation	\$120M	1.68%	18
Business Products and Services	\$94M	1.32%	29
Consumer Products and Services	\$92M	1.28%	18
Computers and Peripherals	\$73M	1.03%	14
Healthcare Services	\$56M	0.78%	13
Retailing/Distribution	\$49M	0.69%	6
Other	\$16M	0.23%	4

Source: Venture Economics. <http://www.ventureeconomics.com/vec/us.html>.

<https://www.pwcmoneytree.com/MTPublic/ns/index.jsp>

Interest Rates and Inflation

Yield 10-Year Treasury

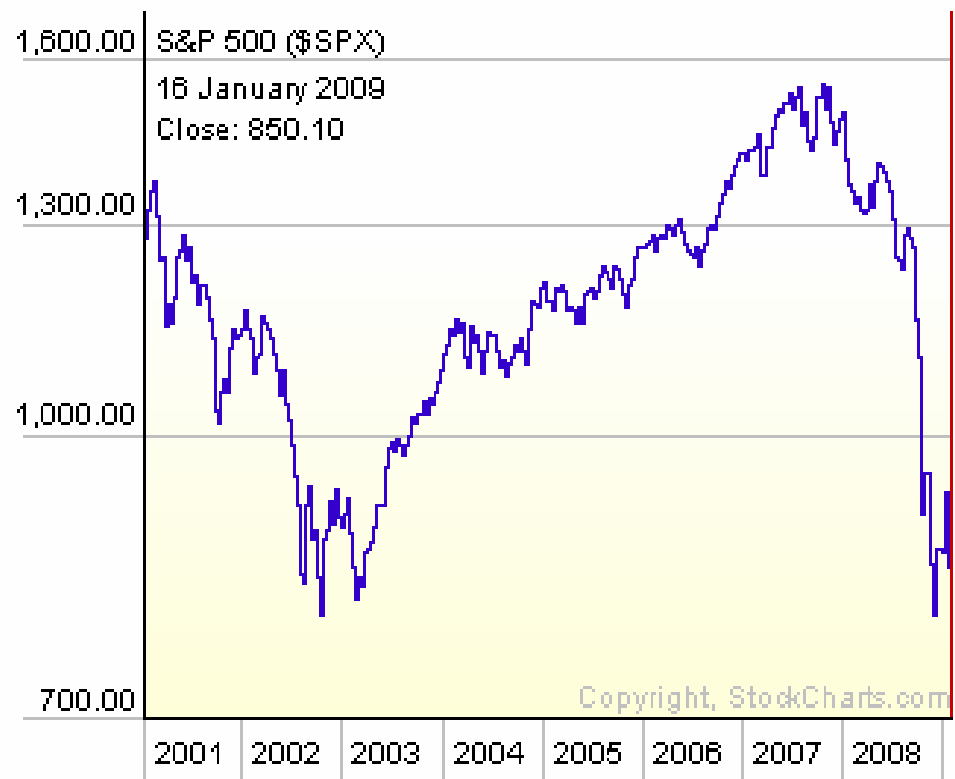
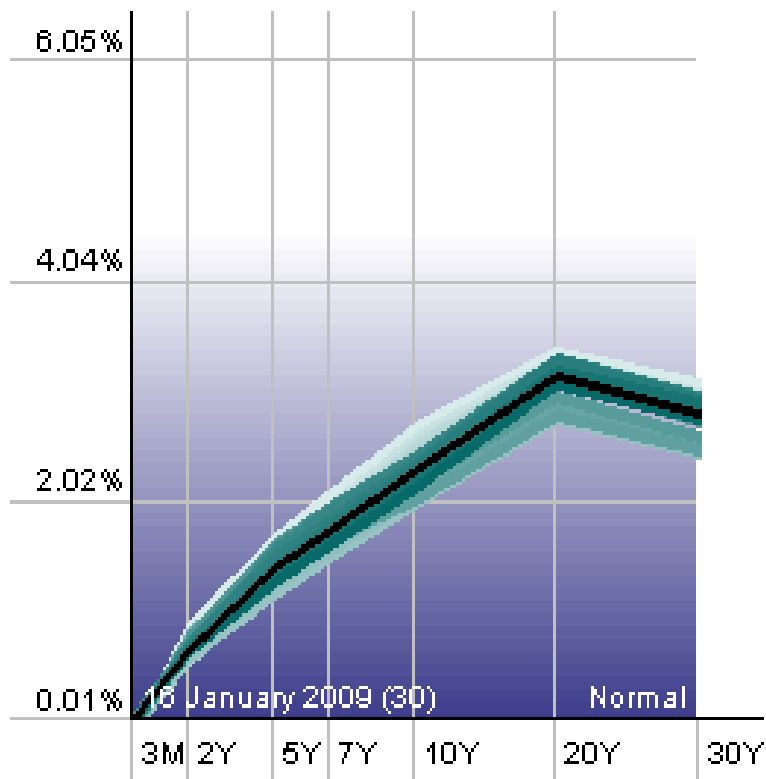
CBOE 10-YEAR YIELD
as of 16-Jan-2009

Imputed Mtg. Int. Rt. $2\% + 2\% = 4\%$



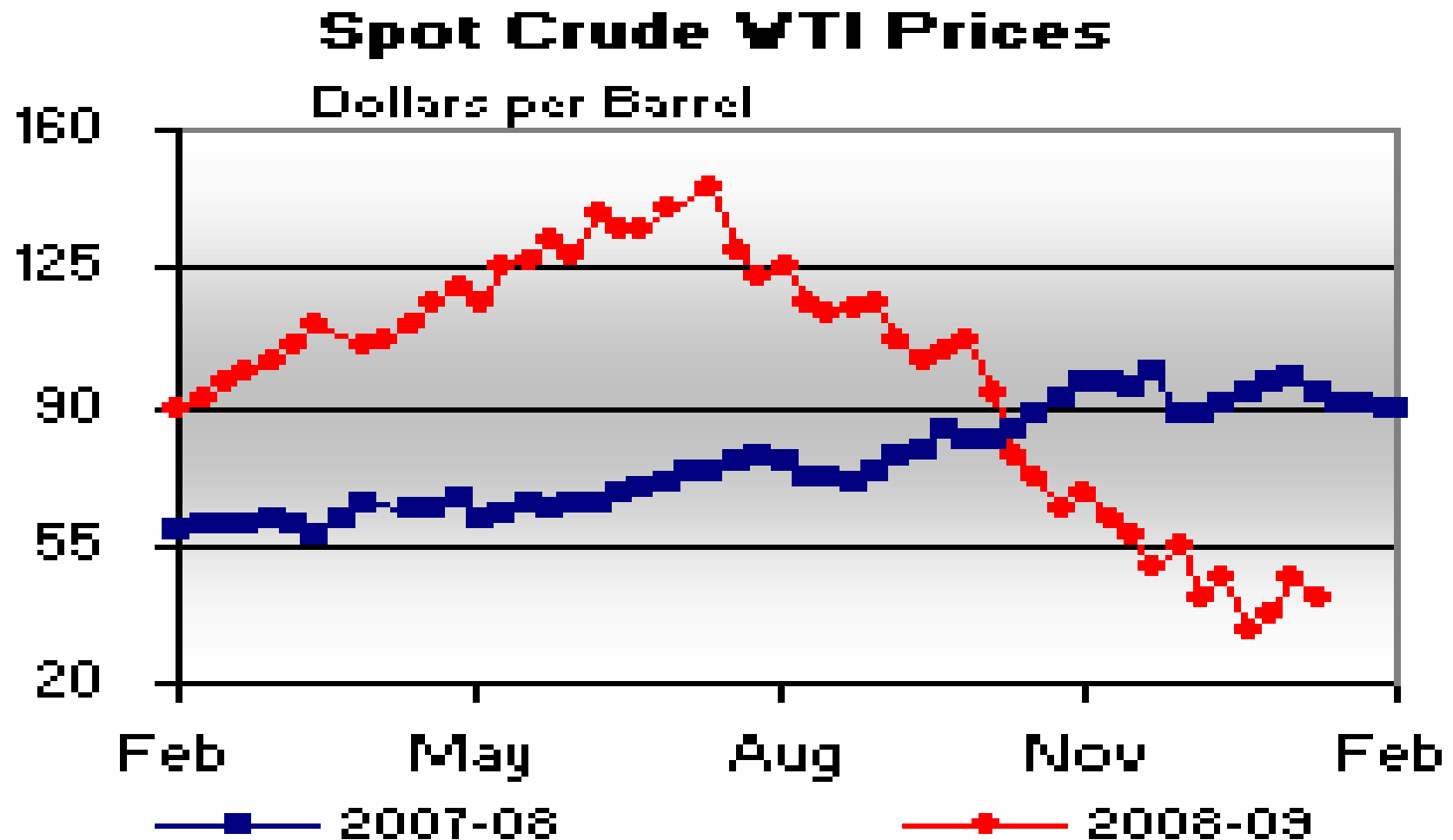
Yield Curve

Dynamic Yield Curve



<http://stockcharts.com/charts/YieldCurve.html>

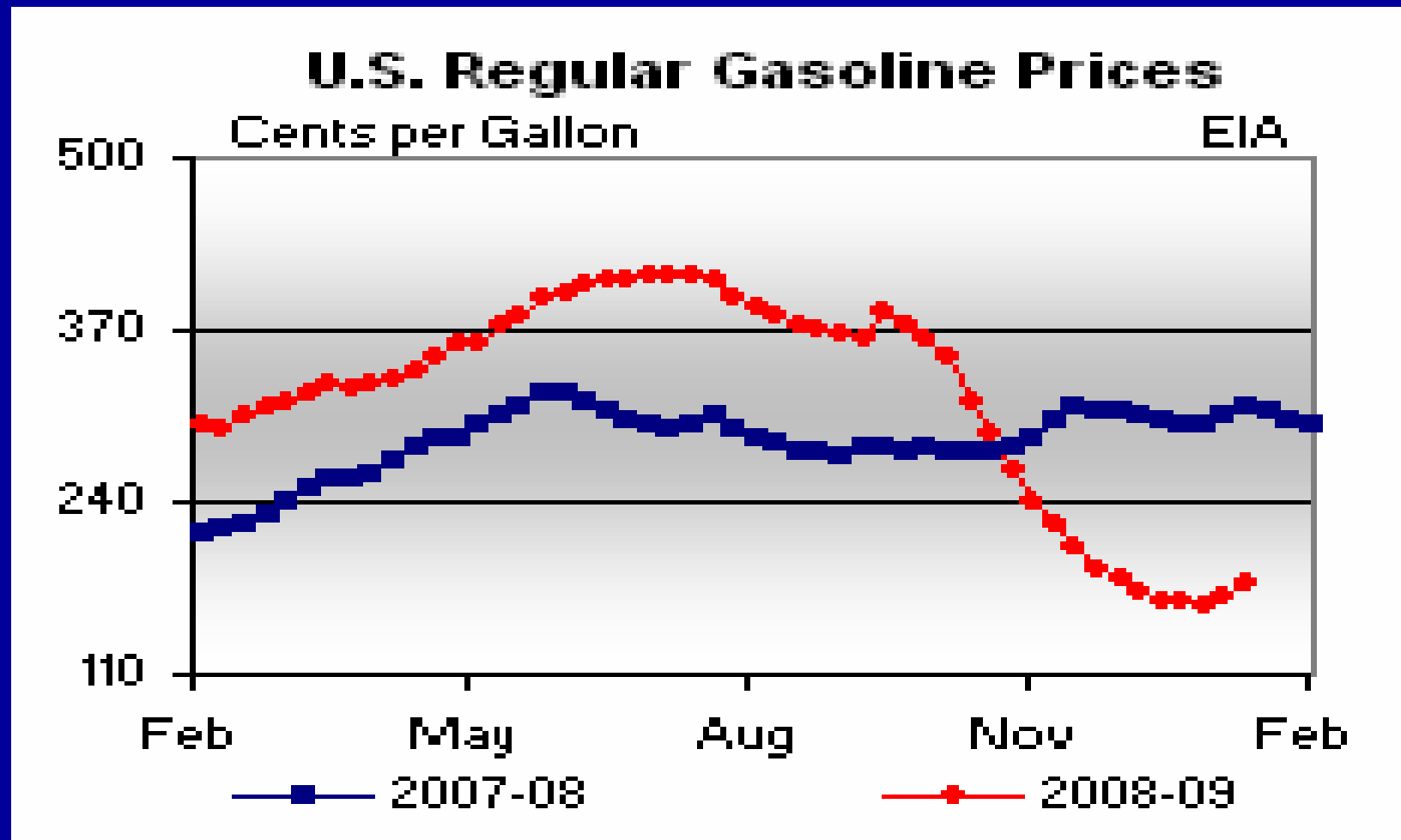
Inflation Expectations



Source: Energy Information Administration (<http://eia.doe.gov/>)

Inflation Expectations

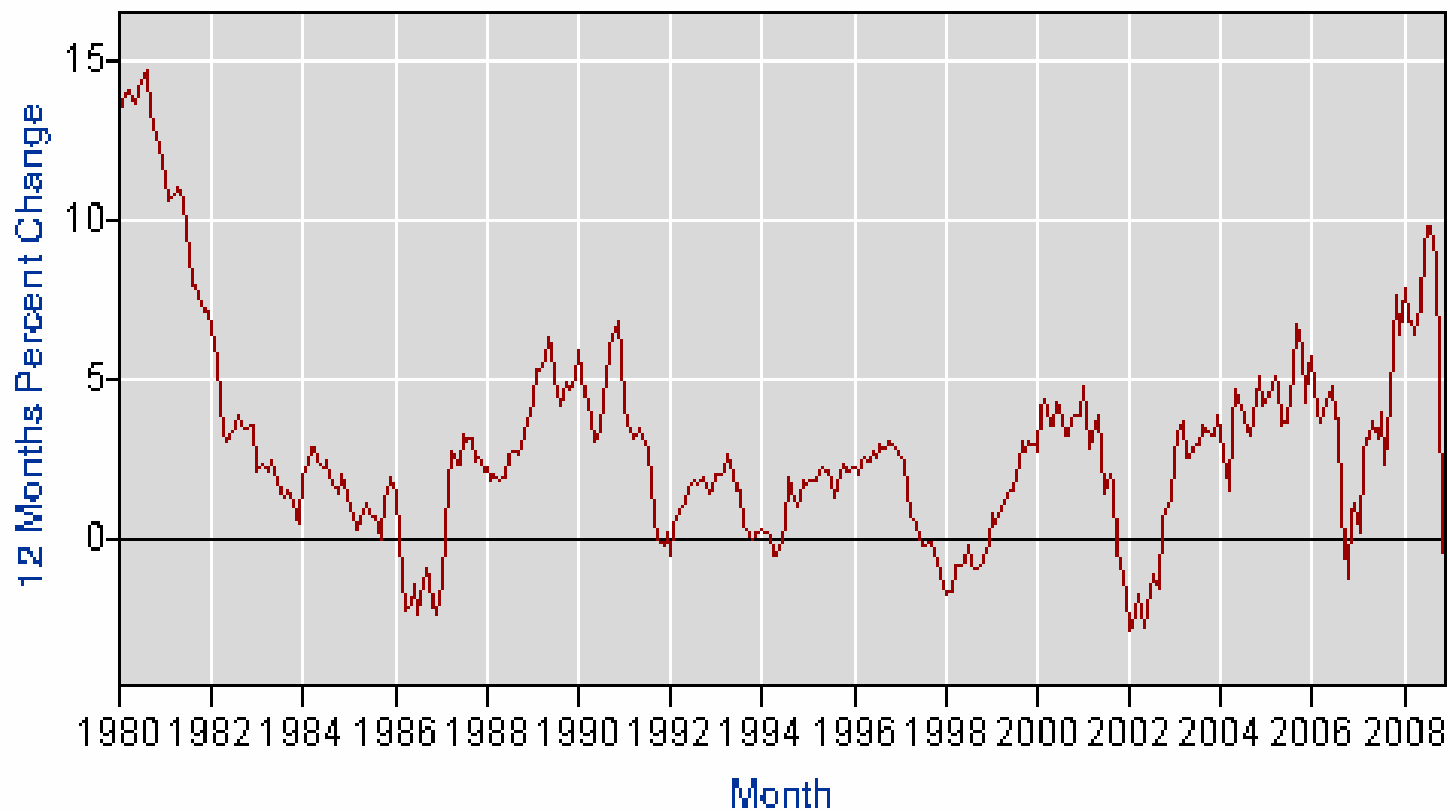
Gas Prices



Source: U.S. Department of Energy, Energy Information Administration, Weekly Retail Gasoline Prices, available at <http://eia.doe.gov/>, as of November 16, 2005. http://www.bts.gov/publications/white_house_economic_statistics_briefing_room/october_2005/html/highway_retail_gasoline_prices.html

Inflation Expectations

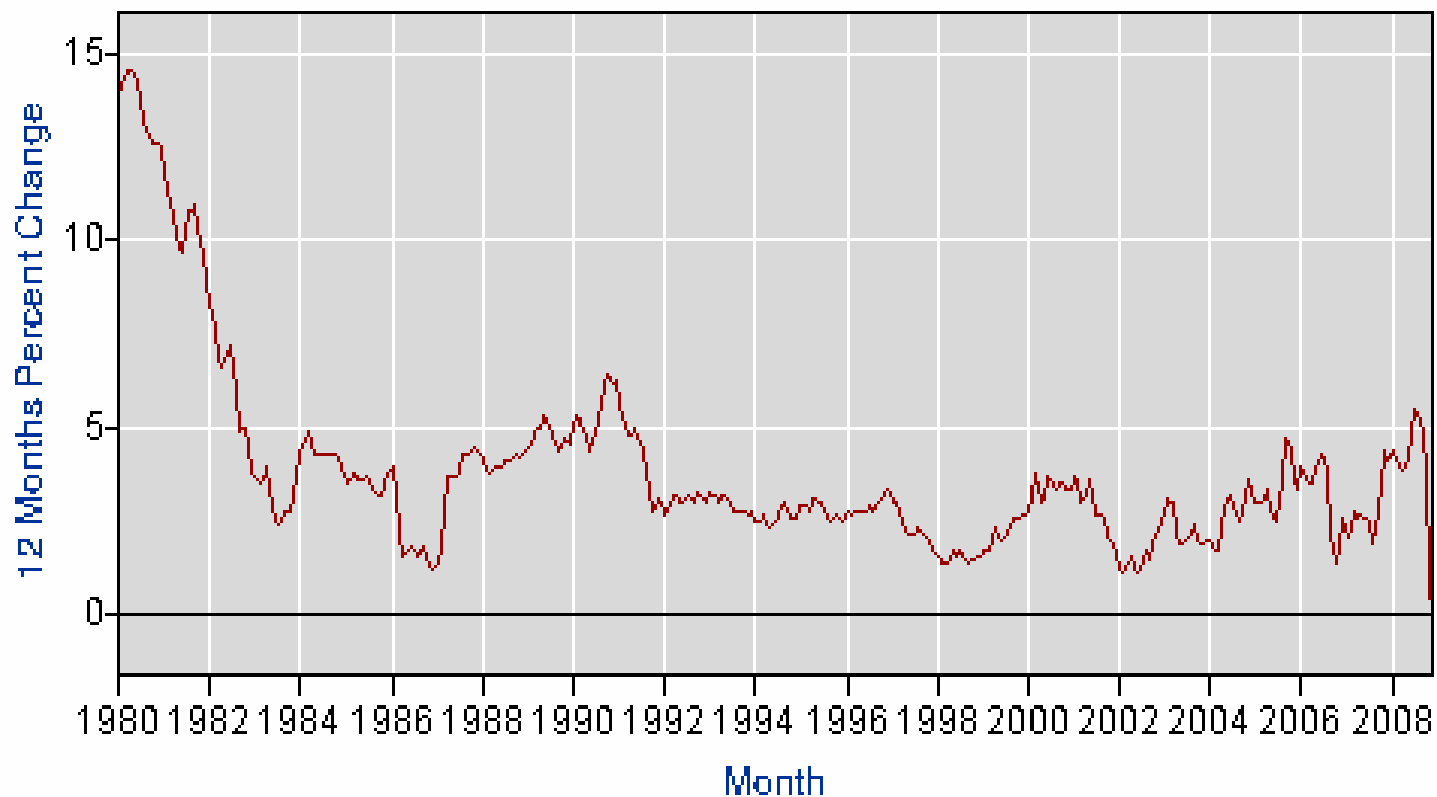
U.S. Producer Price Index (PPI) – Finished Goods



<http://www.bls.gov/home.htm>

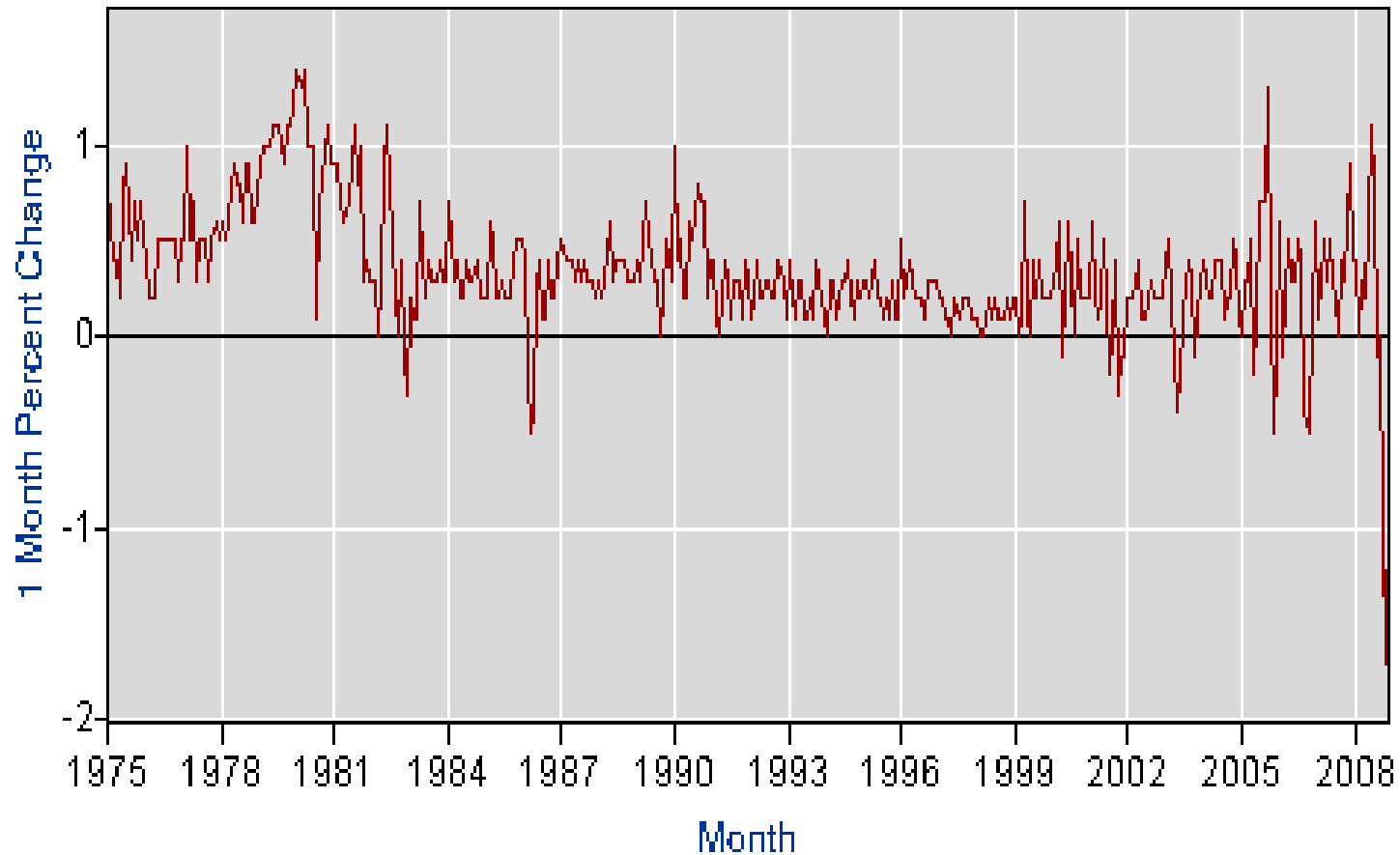
Inflation Expectations

U.S. Consumer Price Index (CPI)



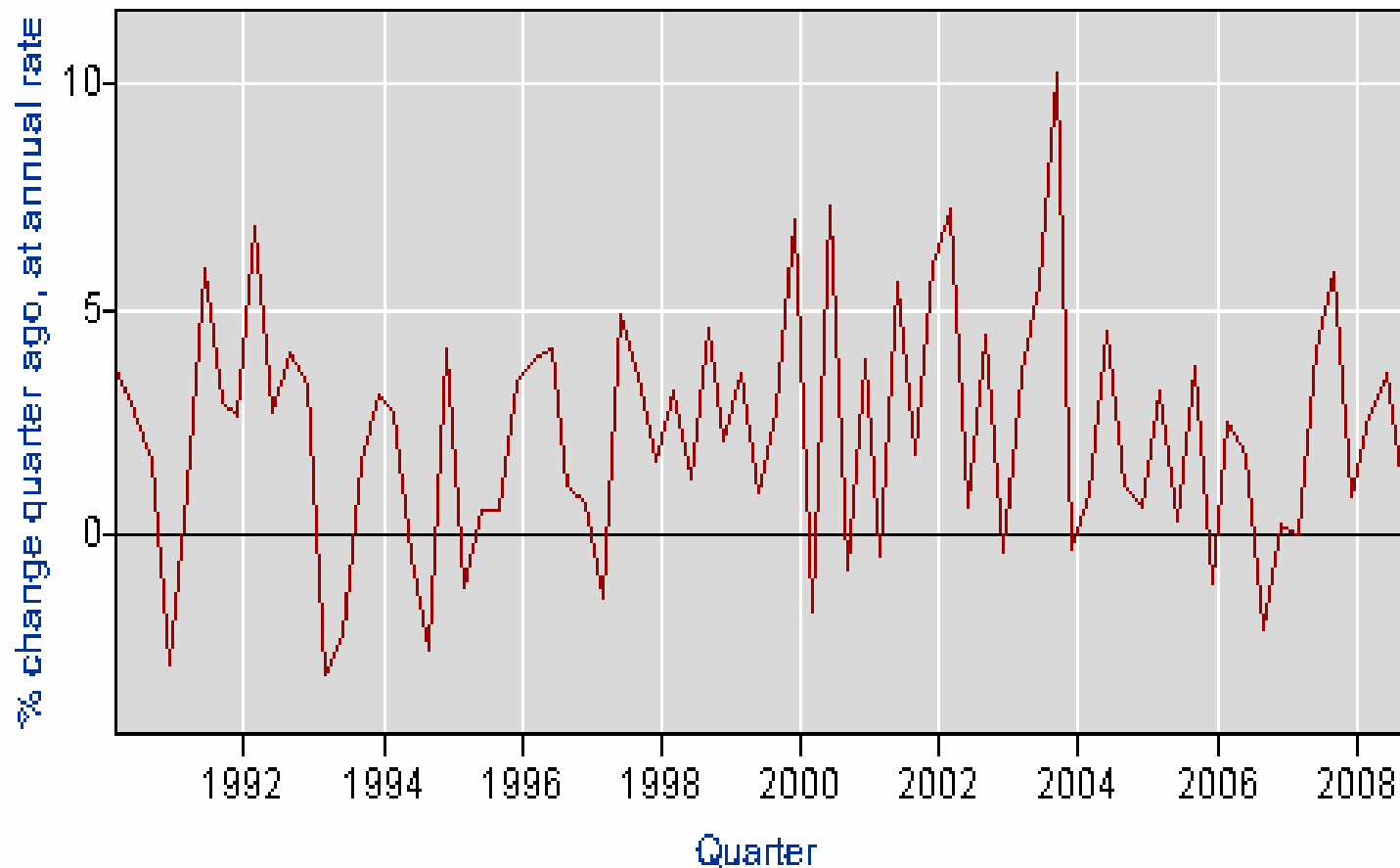
Inflation Expectations

U.S. Consumer Price Index – All Items (U.S. City Average)



Source: Bureau of Labor Statistics.

Non-Farm Productivity (Output Per Hour)



Source: Bureau of Labor Statistics.

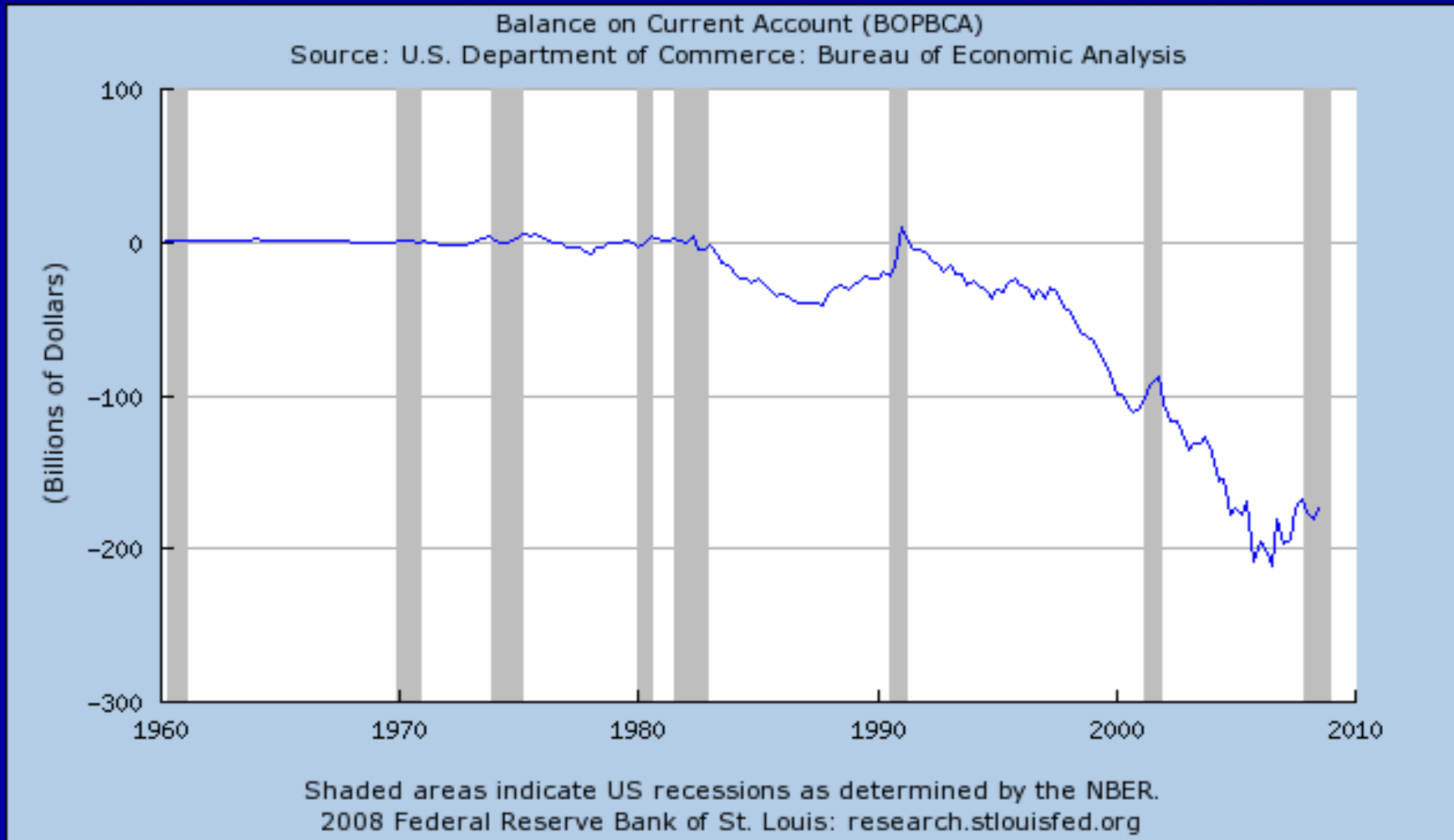
<http://www.bls.gov>

Euro Exchange Rates 2008-2009



Source: New York Federal Reserve Bank. <http://www.ny.frb.org/markets/foreignex.html>

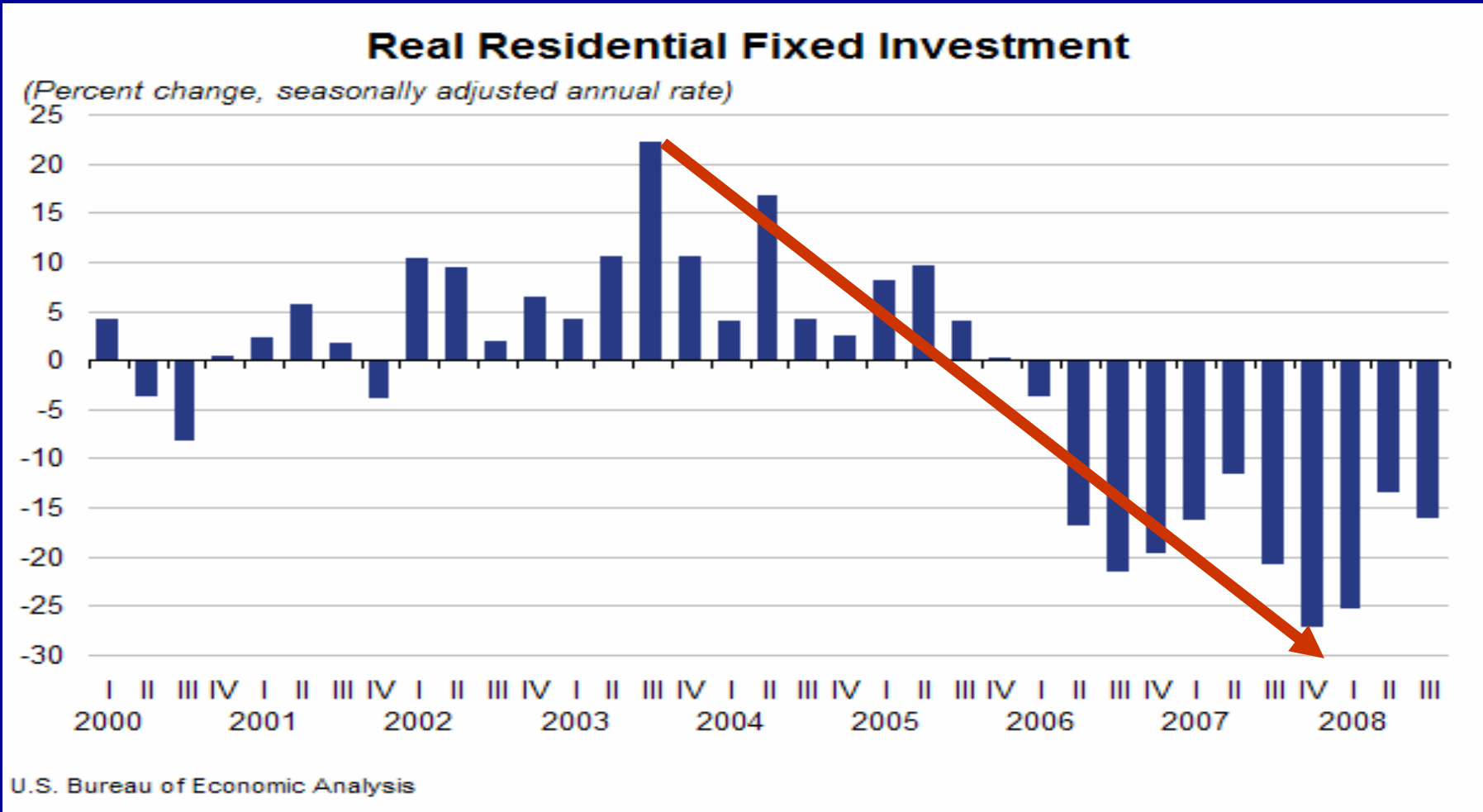
Balance of Trade



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

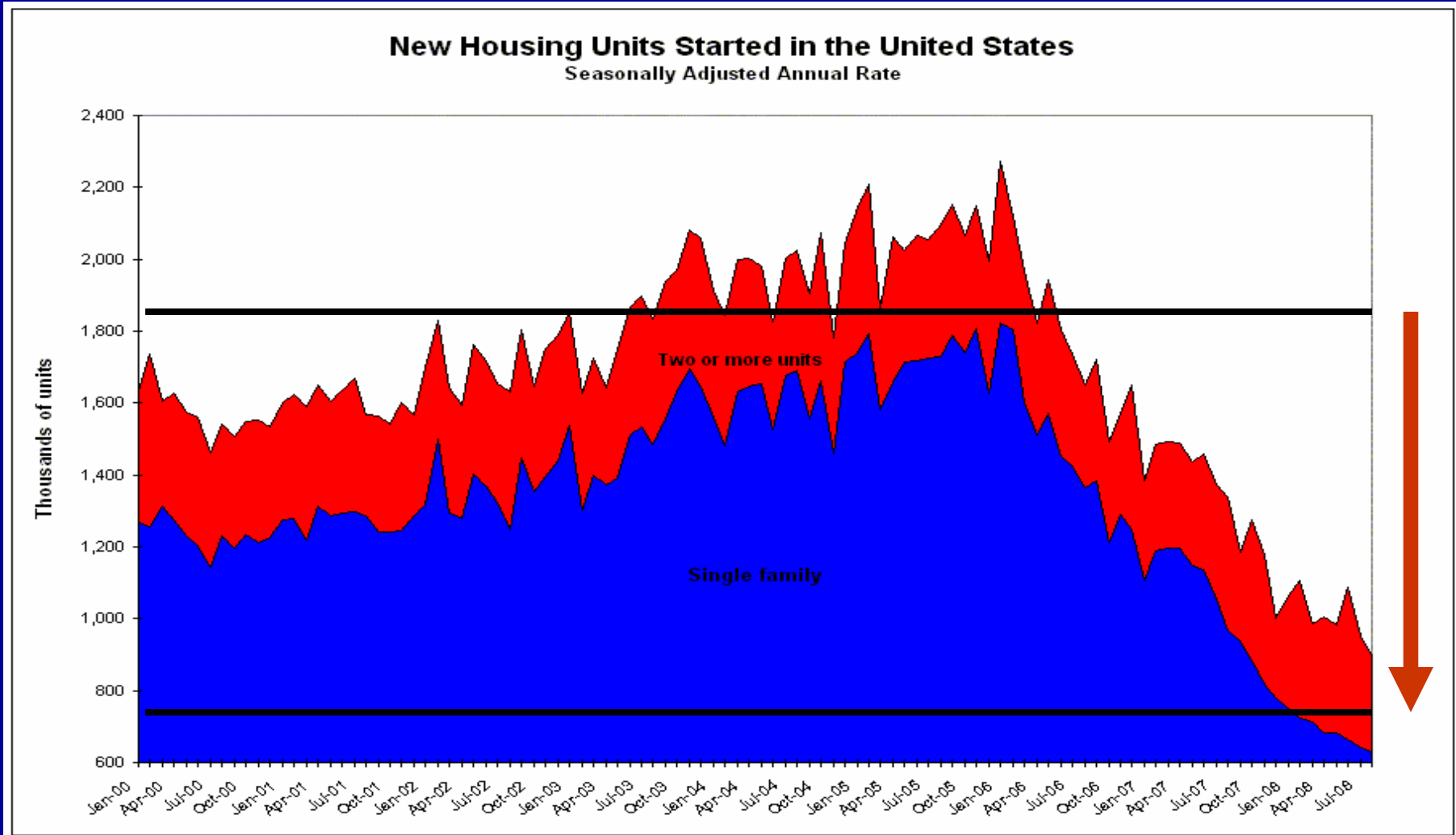
Home Prices and Affordability Rates

Real Residential Fixed Investment



<http://www.bea.gov/briefrm/resfi.htm>

New Housing Starts



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

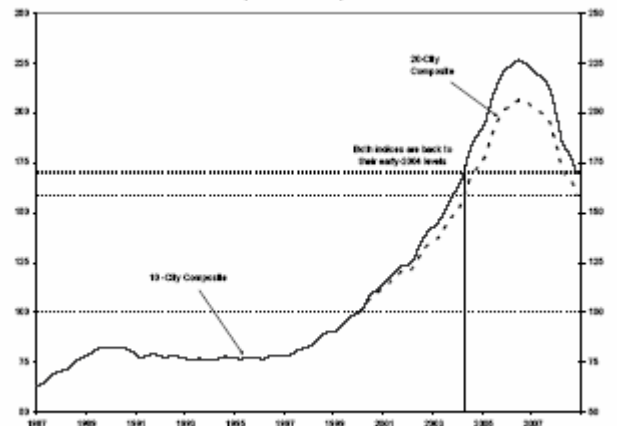
Housing Market – Price Declines

S&P/Case-Shiller Home Price Indices
(Annual percent change)



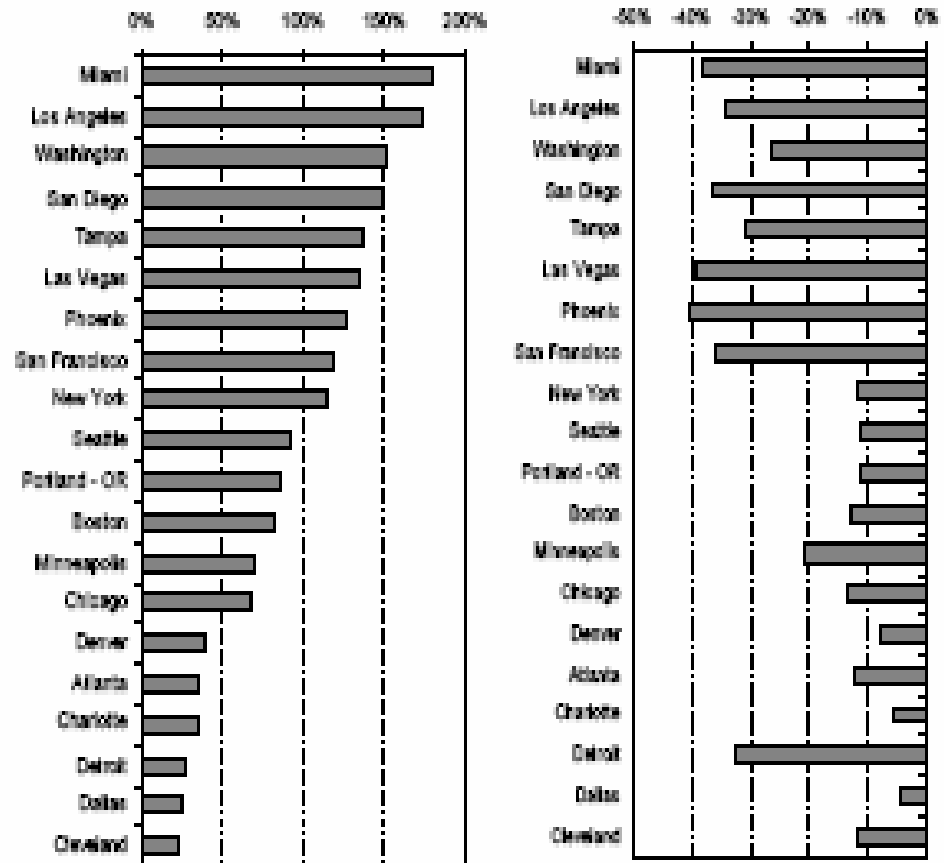
Source: Standard & Poor's and Fannie. Data through October 2008.

S&P/Case-Shiller Home Price Indices
(Index Level)



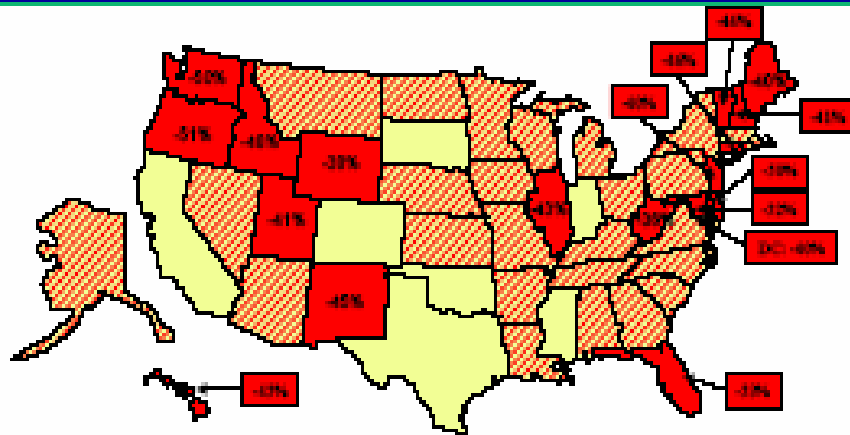
Source: Standard & Poor's and Fannie. Data through October 2008.

S&P/Case-Shiller Home Price Indices
(percent changes)



Source: Standard & Poor's and Fannie. Data through October 2008.

Housing Market – Price Declines



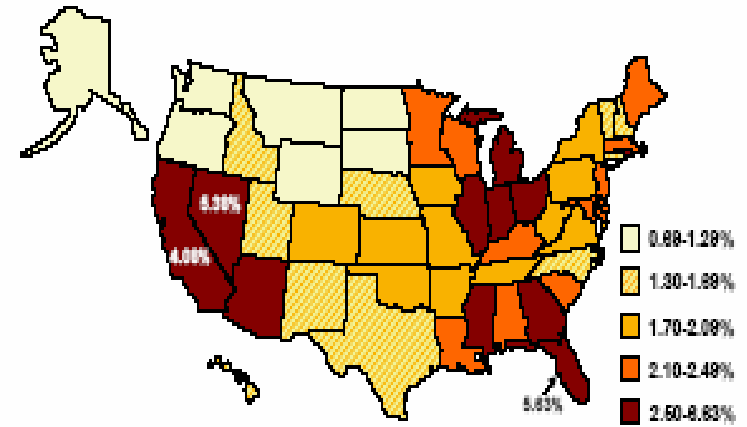
Percent change in existing home sales
Third quarter 2005 through Third quarter 2008

- Down less than 20%
- Down 20-35%
- Down more than 35%

Existing Home Sales
Nationwide Down 30%

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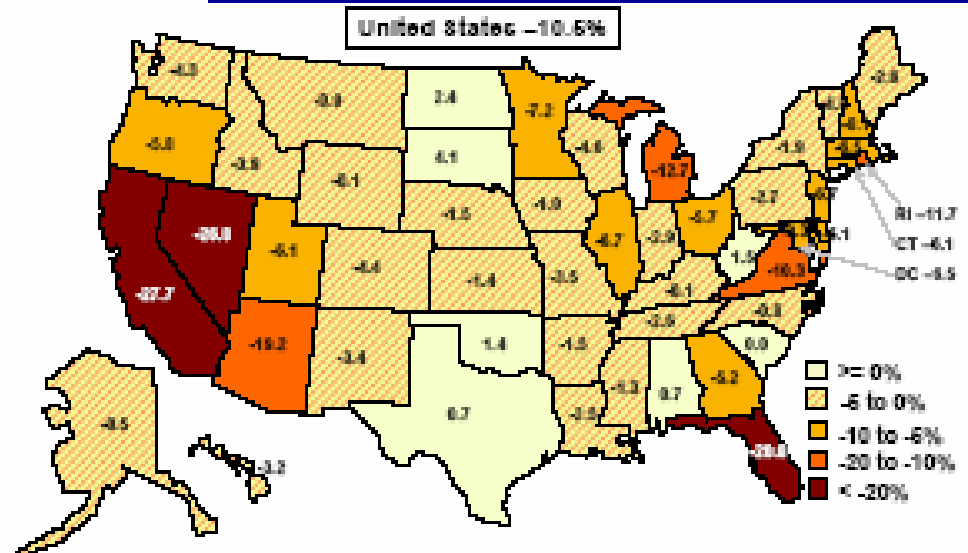
Source: National Association of Realtors



National = 2.87% Seriously Delinquent
(90+ days delinquent or in foreclosure, Prime & Alt-A Conventional)
Data as of September 2008

Source: Mortgage Bankers Association

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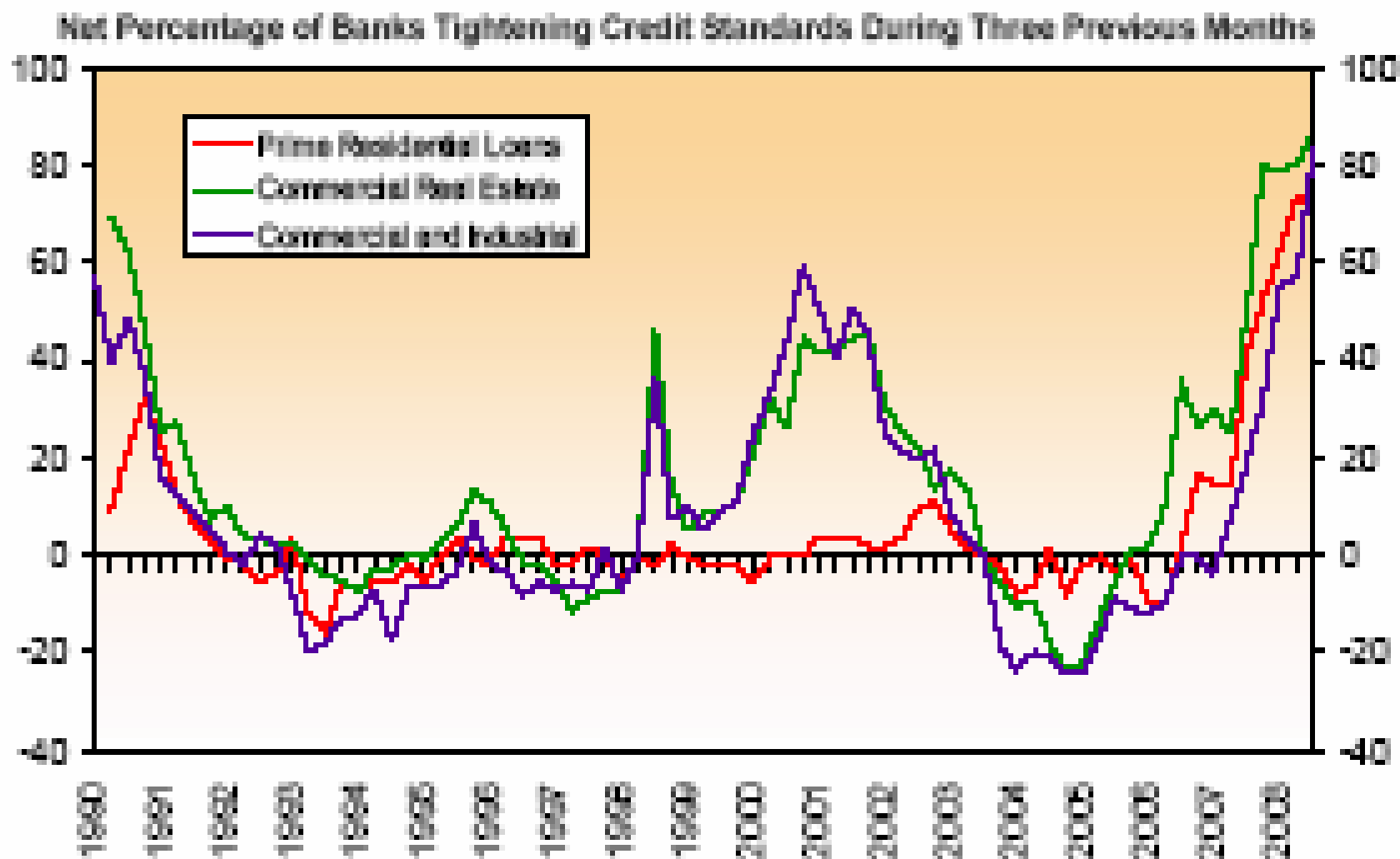
United States -10.6%

- $\geq 0\%$
- 5 to 0%
- 10 to -5%
- 20 to -10%
- $< -20\%$

Source: Freddie Mac

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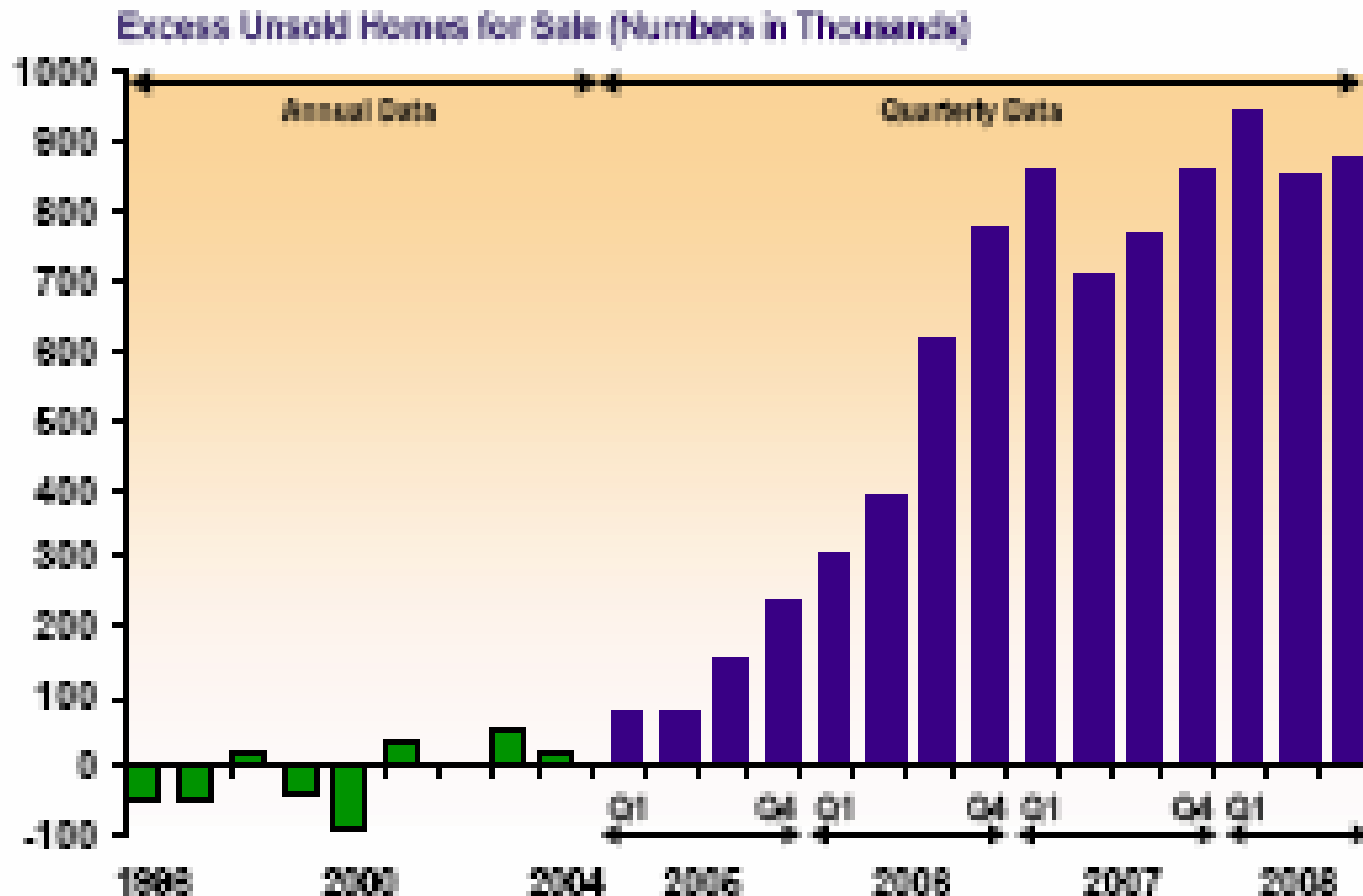
Housing Market – Tight Credit Standards



Source: Federal Reserve Board's Senior Loan Officer Survey (all residential loans through 2007Q1, prime residential starting 2007Q2; C&I loans to large and middle-market firms).
Last update: November 3, 2008

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Housing Market - Excess Inventory

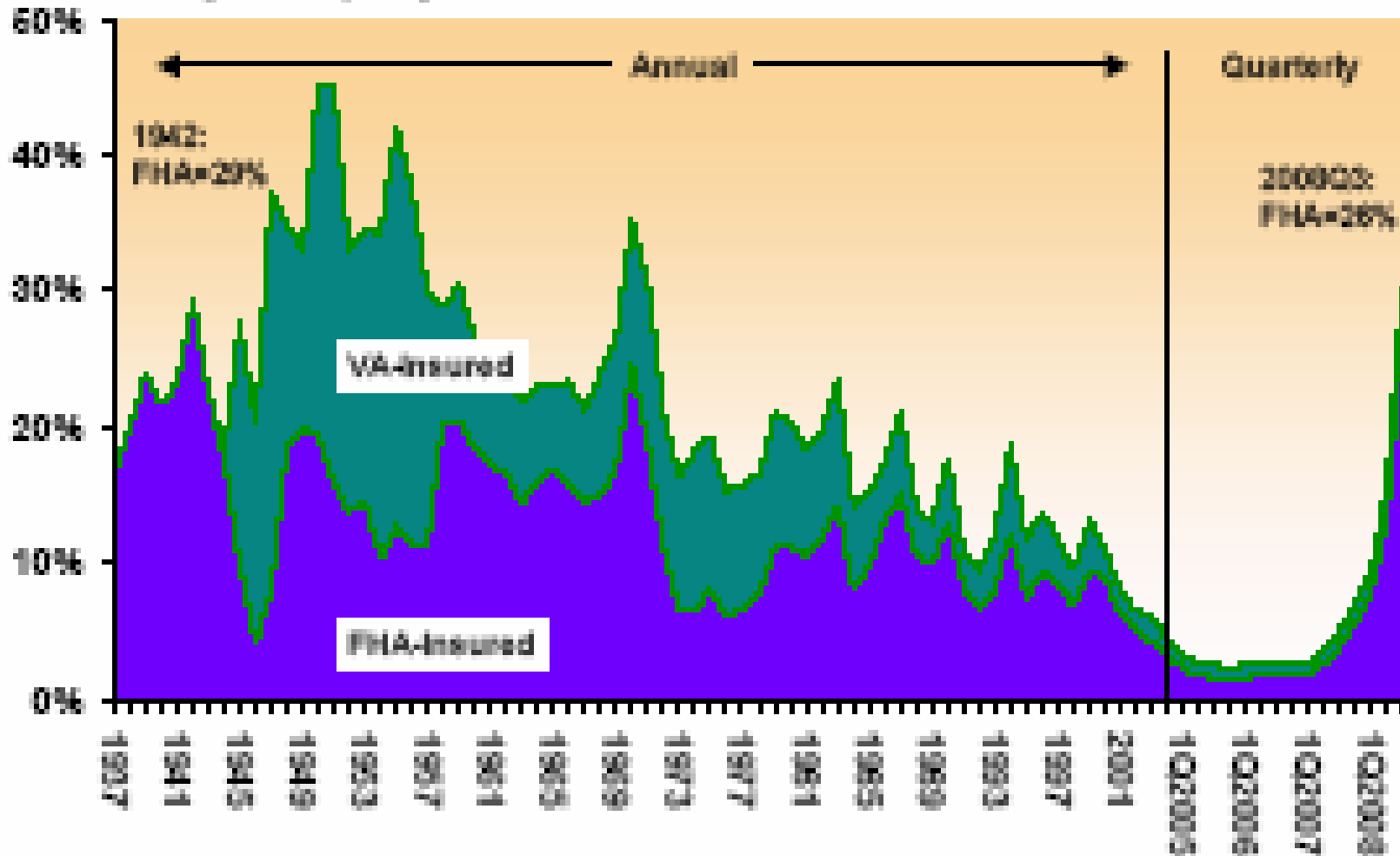


Source: Bureau of Census (1998-2004 Annual Data, 2005Q1-2009Q2 Quarterly Data)
 Note: The excess unsold homes were estimated based on the average vacancy rate from 1999Q1 to 2009Q4 (1.7%).

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Housing Market – FHA Originations

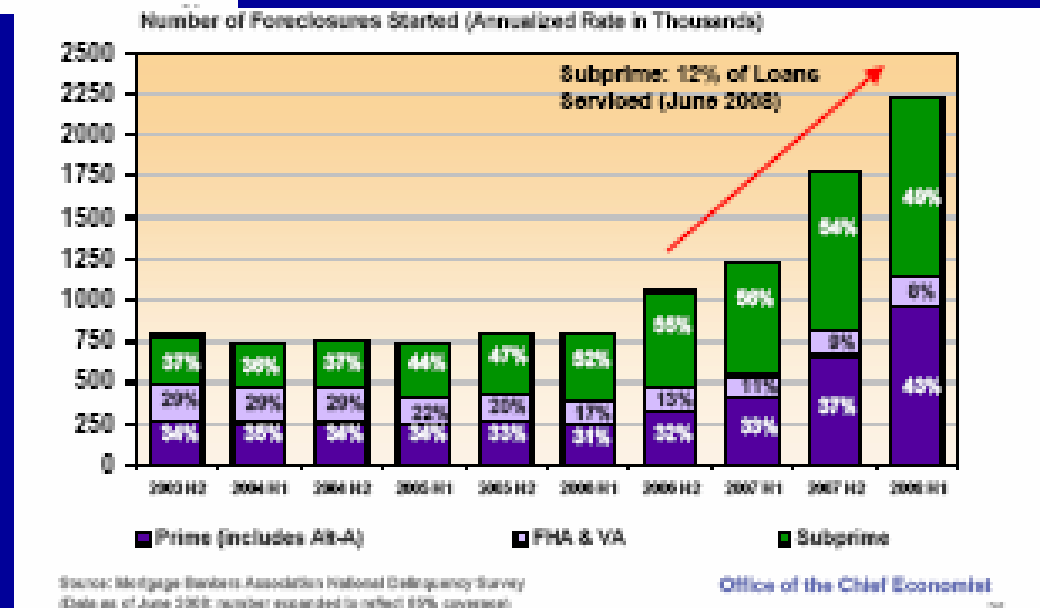
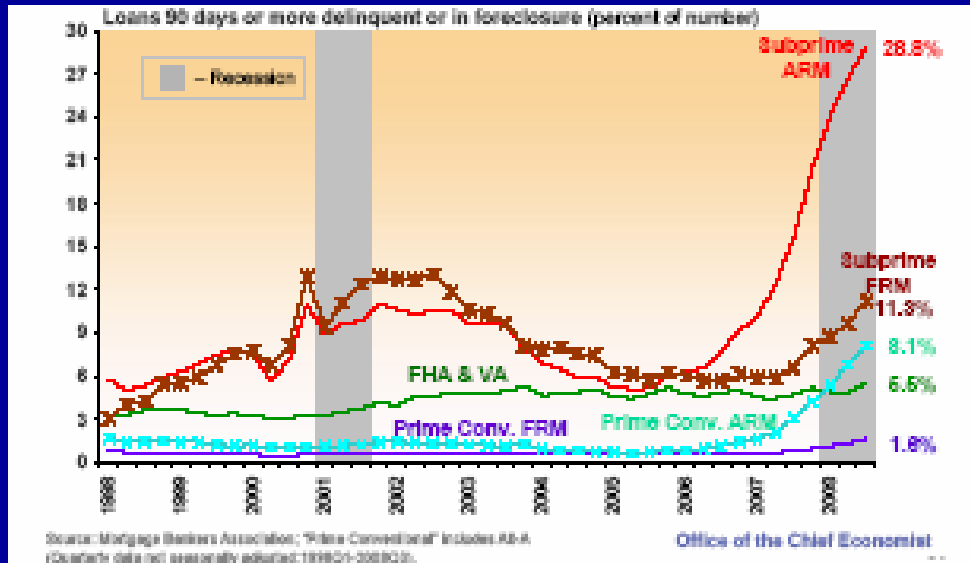
Share of Single-Family Originations



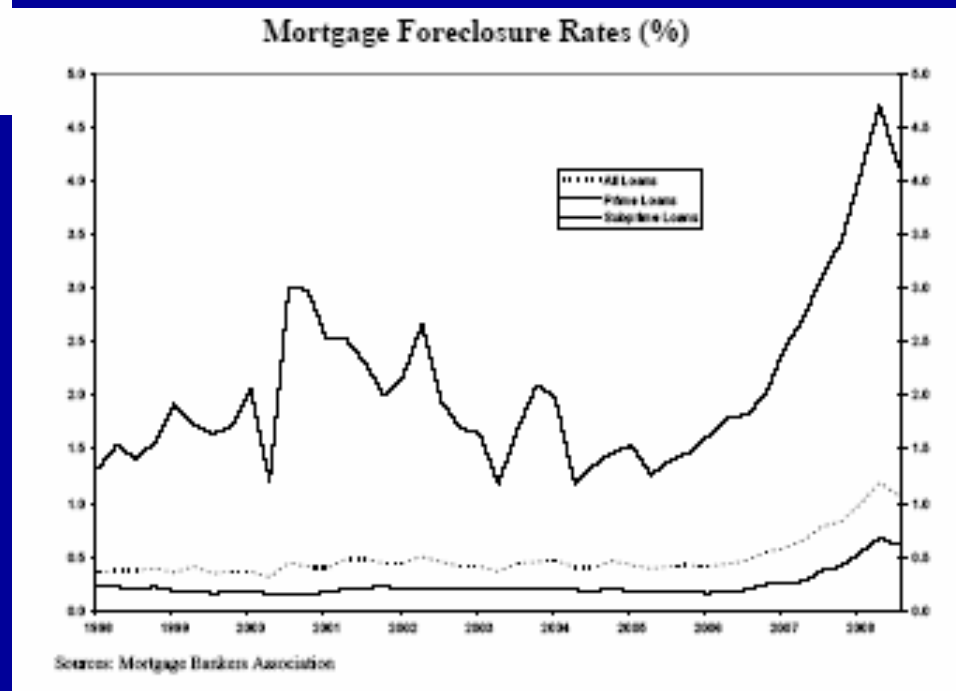
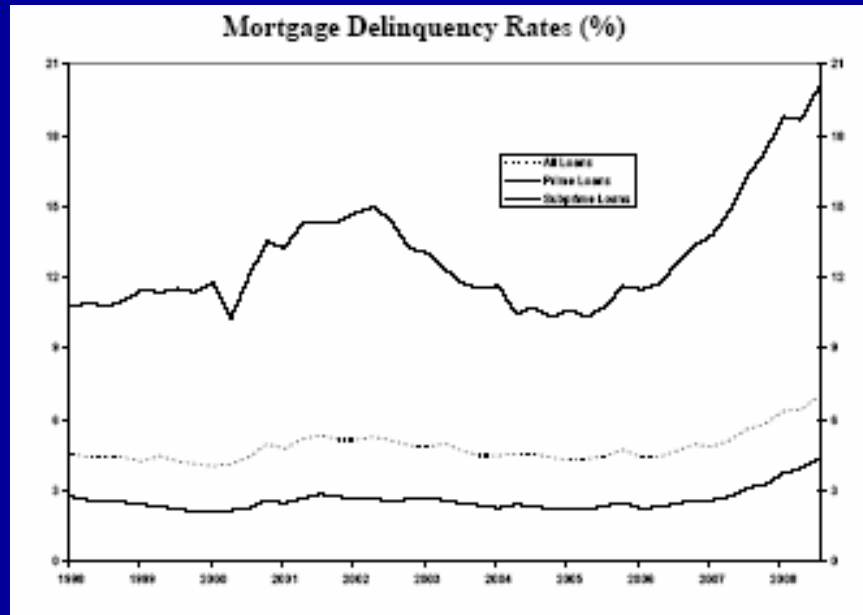
Sources: HUD (1942-1997), Freddie Mac & Inside Mortgage Finance (1998 - Present)

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Housing Market – Default Rates



Housing Market – Delinquency/Foreclosure Rates



Conclusions

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

Commercial Demand

Future job growth-housing demand:

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

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

Lawrence Souza (lsouza@Johnson/SouzaGroup.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.**