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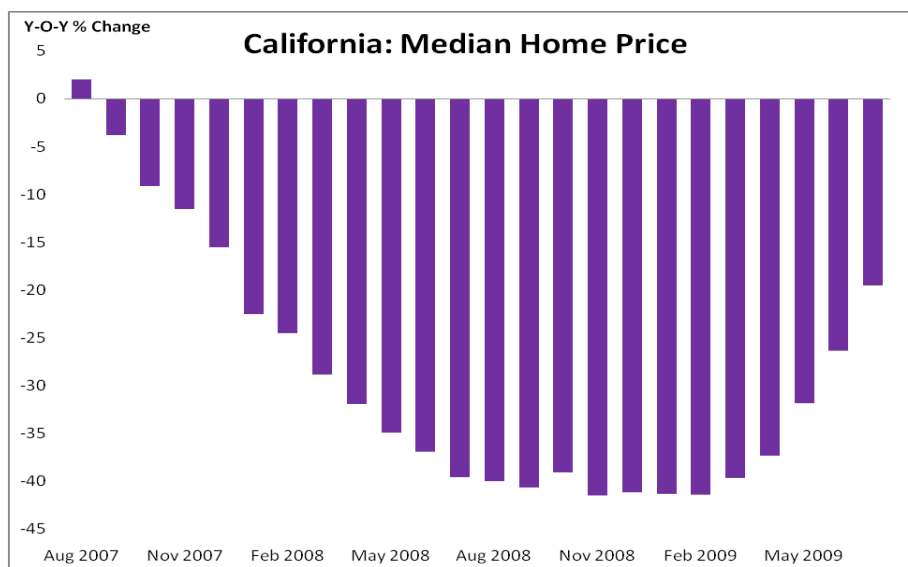
Real estate markets in California, both residential and commercial, are in dire straits. Home prices continue to decline. Commercial vacancy rates are increasing, while lease rates are declining. New construction for residential and commercial real estate is at or near all-time lows. Unfortunately, things are likely to get worse. The State's weak economy, mounting job losses and tight credit will either prevent or slowdown a recovery.

Residential Real Estate

California median home prices have declined for twenty-three consecutive months. In August 2007 the median home price was \$589,000. In July 2009, the last month for which we have data, the median home price was \$285,000. This represents a 51.2 percent decline.

Although this is actual data, some interpretation is needed. What is not captured in these numbers is the change in the composition of home sales. In August 2007 very few foreclosures were on the market. By 2009 this had changed dramatically. As of July 2009, approximately one half of all homes sold were distressed (i.e. foreclosures, short sales). As distressed properties generally sell at a discount, the median home price is artificially reduced by the distribution of home sales.

As a result, traditional, non-distressed homes have probably not fallen 51.2 percent in value since August 2007. To be sure, values for these homes have fallen. However, it is unlikely that they have fallen as far as the median home price would indicate.



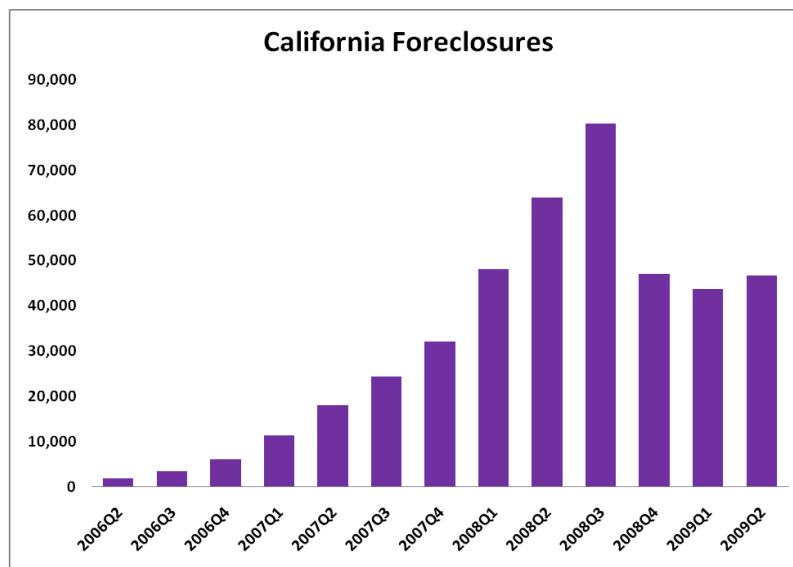
Source: California Association of Realtors

Home sales, on the other hand, are improving. The seasonally adjusted annual rate (SAAR) of home sales is approaching its pre-recession level. In July 2009 the SAAR was 554,000 homes. This is significantly better than the 255,000 reading in October 2007, just after the collapse of Lehman Brothers.

Although this is encouraging, caution must be used when evaluating the increase in home sales. As previously mentioned, the majority of home sales are coming from distressed properties. This is good news because these sales are soaking up the excess inventory. However, it also implies that the market for traditional, non-distressed homes is still weak.

Foreclosures remain the biggest problem facing the residential market. After peaking in Q3 2008 at 80,391, foreclosures have declined in recent quarters. Nonetheless, they are significantly above the long-term average. Foreclosure moratoriums have played a significant role in reducing foreclosures. Unfortunately, we cannot expect moratoriums to continue indefinitely.

Foreclosures have averaged 45,845 over the last three quarters. At this rate, 183,380 California homes will be lost to foreclosure in 2009. This is in addition to the 325,751 home that were lost in 2007 and 2008. Foreclosures will continue to negatively impact California residential real estate well into 2010.



Source: DataQuick

As we move forward what can we expect in the California residential real estate market? In general, we can expect the market to remain depressed for some time to come. California's weak economy and climbing unemployment rate will prevent a meaningful recovery. Consumers concerned about future employment are not likely to purchase homes. Mounting job losses will translate into more foreclosures. This in turn will keep downward pressure on the market.

With that said some markets will do better than others. We expect coastal communities to outperform inland communities. In general, inland areas experienced a building boom prior to the recession. These communities attracted workers who choose longer commutes and cheaper housing. As these workers lose their jobs and their homes, they tend to move to job centers along the coast or leave the state entirely. Consequently, the demand for housing in the inland areas is likely to be depressed. These markets are not expected to recover until the California economy recovers.

Coastal communities, on the other hand, did not experience a building boom to the degree that inland communities did. Lack of available land and higher prices kept new development in check. Relative to inland areas, coastal communities have a smaller over-supply problem. This will help these communities recover faster.

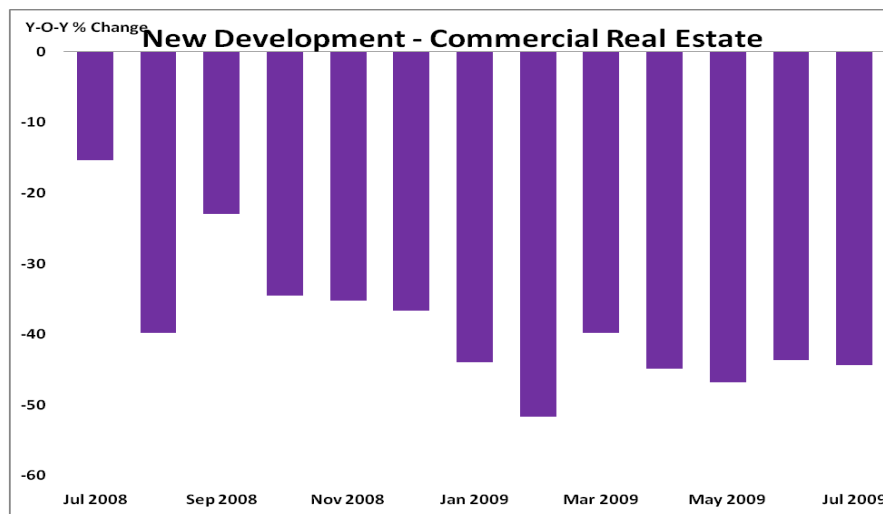
It should be noted that the recovery in coastal communities is unlikely to be robust. The state’s weak economy and increasing unemployment rate will keep residential markets along the coast subdued for the foreseeable future.

Commercial Real Estate

Commercial markets are just as bad as residential markets, if not worse. Vacancy rates continue to increase across the board. Higher vacancy rates are translating into lower lease rates. Tight credit markets are restricting the number of transactions. Commercial real estate markets throughout California are under duress.

Problems in the commercial real estate can best be exemplified by new development. Year-over-year new construction in California’s commercial real estate markets has declined 41 consecutive months! At the moment, there is so much excess inventory in the market that very little new construction is taking place.

The following chart shows the decline in new construction from July 2008 to July 2009. On average, year-over-year new construction has declined 38.4 percent over this period.



Problems persist in all sectors of the commercial market, retail, office, and industrial. The retail market represents the most problematic of the sectors. Retail sales in California are declining. As consumers save rather than spend, retail sales will continue this trend. This will exacerbate the problems in retail. In particular, we expect a poor holiday season in 2009.

The lack of consumer spending will put significant pressure on all types of retailers. The only subsector that may escape this downward trend is discount retailers such as Wal-Mart. During difficult economic times consumers tend to substitute away from higher priced retailers. Retailers with low price points may gain market share at the expense of their higher priced competition.

Office and industrial markets throughout California continue to suffer. The lack of economic activity has significantly reduced demand for space. This trend is likely to continue as California's economy contracts even further.

The large, inland industrial areas will experience the largest declines. Vacancy rates in the Inland Empire are approaching, if not exceeding, 20.0 percent. With this much supply on the market we expect lease rates to fall even further and tenant improvement monies to continue increasing.

The outlook for California's commercial real estate markets is not good. Each market is characterized by excess capacity. Given California's negative economic growth, it is going to take quite a bit of time to absorb the excess capacity that exists in the commercial markets. Until the excess capacity is reduced, we expect high vacancy rates and low lease rates to dominate all sectors of commercial real estate.