Real Estate Trends in the Sacramento Region

2009 Mid-Year Update

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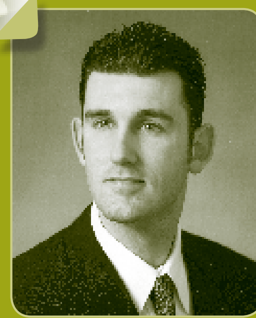

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Mid-way through 2009, the Sacramento commercial real estate market continues to struggle. With the economic recession about to become the longest and deepest on record since the Great Depression, and its primary cause - the residential market - continuing to flounder in search of a bottom, the commercial sectors show no signs of healing soon.

Retail

- Contract rents in the retail sector declined dramatically during the first half of the year, dropping 30% - 50% across the board. With a major lack in tenant activity, especially from national retailers, landlords are going to extreme measures to retain tenants, including reducing the rent on existing leases.
- A few notable bankruptcies were announced during the first half of the year, including Anchor Blue, Eddie Bauer, and Gottschalks, while Borders narrowly escaped filing bankruptcy. Smith & Hawken also recently announced the closure of all 56 of their stores nationally, including one in Roseville. We anticipate a few additional high-profile bankruptcies will occur during the second half of the year.
- Discount stores continue to do well in this economic environment. Wal-Mart opened a new Supercenter at the Florin Towne Centre (formerly the Florin Mall) in June, and The Goodwill Store, Ross Dress for Less and Winco Foods continue to plan for expansion. PetCo and CVS are also actively looking in the market for space.
- We have seen an increase in anchor and junior anchor space come available with the demise of Gottschalk's, Mervyn's, Linens & Things, Circuit City, Shoe Pavilion, Office Depot and a few others. Landlords are now considering less traditional types of tenants to backfill these spaces, including churches, trade schools, temporary or seasonal users, and thrift stores.

Office

- Regional vacancy increased from 16% to 21% since the beginning of the year, which is significant because it is the first time in Sacramento's history that office vacancy has exceeded 20%. The submarkets hit the hardest are the "new growth" areas of Elk Grove and Roseville/Rocklin with vacancy rates of 39% and 34% respectively.
- The state of California remains the most active tenant in the marketplace, as it continues to add to its overall square footage under lease. Additionally, the state recently initiated an effort with landlords to renegotiate all but its most recent leases, offering to extend them for a reduction in rent. Known as "blend & extending," this cost-cutting effort has met with some early success.
- Leasing activity in the private sector is down substantially over 2008 levels. The most common leasing activity continues to be lease renewals with shorter terms (12-24 months) and, in many cases, early termination options as tenants remain highly cautious about the uncertain economic environment.

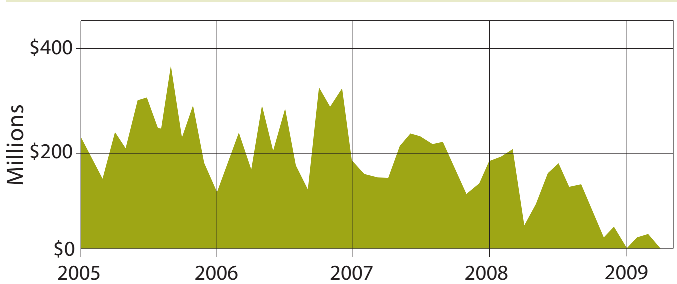
Industrial

- The most resilient real estate sector to date in the current economic crisis has finally seen its rental fundamentals deteriorate considerably during the first half of 2009, as regional vacancy increased from 8.4% to 11.6%. The most challenged submarkets are McClellan Park (33.1%), Woodland/Davis (17.5%), Northgate/Natomas (15.3%), and Roseville/Rocklin/Lincoln (15.2%).
- Net absorption – the change in occupied square feet from one period to the next – has been significantly negative during the first two quarters, with 4.1 million fewer square feet occupied today than at the beginning of the year. If this pace continues through the second half of 2009, it will take several years for this sector to recover.
- The most common leasing activity continues to be lease renewals with shorter terms, as industrial tenants also remain highly cautious in the current economic environment.

Investments

- Investment sales activity slowed to a crawl during the first half of 2009. While buyer capital is plentiful and there is great anticipation of some fantastic investment opportunities on the horizon, many would-be buyers believe the market will continue to degrade, keeping them on the sidelines with the expectation that assets will become even cheaper.
- Commercial REO (real estate owned by banks) activity is just now beginning to occur and, together with other types of distressed assets, will represent a large portion of the sales activity going forward. However, banks are having difficulty understanding the assets they have and what to do with them, which is prolonging the REO process. As a result, it is taking longer for distressed assets to become available for sale, pushing out the correction by several months. Although we will see REO offerings during the second half of this year, we expect the bulk of REO sales across all commercial sectors will occur in 2010.
- With the exception of the multi-housing sector, which benefits from the availability of loans from Fannie Mae and Freddie Mac, credit options for commercial real estate remain limited.

Figure 1 – Investments
Sales in Dollars Per Month through May 2009
(all property types)

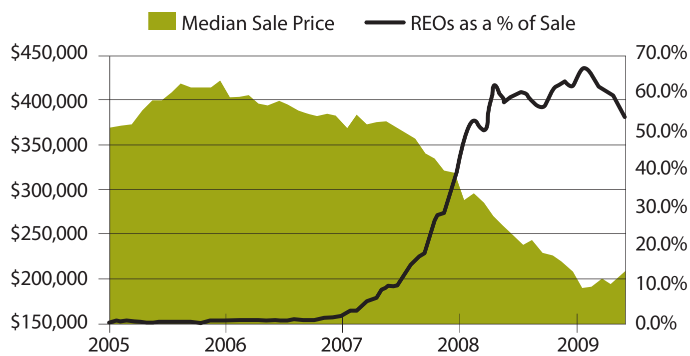


Note: Monthly, reported closed. Source: Real Capital Analytics

Residential

The federal government's bailout of the banking industry appears to be prolonging the down-cycle as banks, bolstered by government capital, are better able to hold REO inventory and delay taking ownership of homes on which they are not receiving payments. Banks are doing this for a variety of reasons, ranging from inadequate staffing to a strategic plan to avoid selling at the depressed prices that would result if they flooded the market with homes. They are also making a more aggressive attempt to workout and/or modify loans where possible. To the extent that their modification efforts are successful, it will benefit the market. However, many of the early loan modifications, which took place last year, have ended up back in the REO pipeline. Lender "shadow" REO inventory, along with an indefinite supply of future REOs as the region continues to shed jobs, is the real wild card in the timing of a recovery. Until lenders sell a large portion of their REO assets, and the pipeline of new REOs begins to dry up, it will be difficult to gauge when the market will bottom out.

Figure 2 – Median Sale Price (all Homes) vs REOs as a %
Sacramento MSA



REO (Real Estate Owned) - property which is in the possession of the lender as a result of foreclosure.

Source: MDA DataQuick

- California recently stopped accepting applications for its new-home tax credit worth up to $10,000, which had helped encouraged new home sales. The building industry is lobbying for an extension of the tax credit, but it is unclear whether this effort will be successful.
- The median sale price in the Sacramento MSA has stabilized over the past few months, due to a change in the composition of sales. We are beginning to see more expensive homes sold as REOs, which may actually raise the median sale price during the second half of the year despite the lack of any price appreciation.
- REOs continue to represent the bulk of the sales in the region and will continue to play a significant role in the sales market through 2010.
- Foreclosure notices, including a Notice of Default, Notice of Trustee's Sale, or Notice of Transfer has risen substantially during the first half of 2009. We expect this trend to continue and that foreclosure notices will remain at elevated levels well into 2010.