Housing and Real Estate Markets: Whither California?

Good morning. I am pleased and honored to speak to you today. Although the challenges of getting to Westwood from the recesses of Orange County have limited my involvement with the Ziman Center, I follow their research closely and am always interested to hear Stuart Gabriel's latest pronouncements. The presentations we have just heard should give us all a lot to think about in terms of where the economy is and where it might be headed. But I'm going to talk to you from my perspective as a developer active in both northern and southern California, and whose financial partner, the Related Companies in New York, is one of the nation's largest privately held real estate companies and almost certainly its most diverse. Today, the combined Related Companies have over $15 billion in assets and another $15-$20 billion in some stage of development.

As a developer in California, I live in two different worlds. On one side of our business, we are one of the most active developers of affordable rental housing in California, utilizing the federal low income housing tax credit program and what, until recently, was an array of state and local programs to develop and acquire and rehabilitate apartments for low- and moderate income households. We have over 60 projects in 20 cities throughout the state, including all the major cities, that range in size from 26 units in the heart of beautiful downtown Laguna Beach to a 700 unit acquisition and rehabilitation of an old HUD-insured project in San Jose. We have built over 1,600 units of affordable senior housing; redeveloped five obsolete public housing sites, in Los Angeles, San Francisco and Oakland, into new mixed income communities; created a model for "intergenerational housing," in which we have developed three projects that combine housing for seniors and families, with shared facilities, on a single site; and we recently completed our first project, in East Hollywood, providing permanent supportive housing for the homeless.

In the other "world," we develop large scale, urban residential and mixed use projects that draw on our company's experience as the largest developer in New York City. These include The Century, a 140 unit, 40 story condominium tower in Century City which is arguably the most luxurious condominium project on the west coast; The Paramount, a 40-story, 487 unit apartment tower in downtown San Francisco that has been the market leader in rents since it opened in 2001; two apartment projects in downtown LA's Little Tokyo neighborhood; and, of course, the Grand Avenue project near Disney Concert Hall in downtown LA, which has been on hold but on which there is now significant progress, which I will describe a bit later.

In some cases, these two worlds overlap. As many of you probably know, we started construction in January on The Village at Santa Monica, a 3 acre site on Ocean Boulevard leased from the City that will include 158 luxury condominiums in two buildings, a third building including 160 affordable apartments, and 20,000 square feet of retail space. And all of our market rate rental developments, including most in Manhattan, are financed with tax exempt bonds, so 20% of the units must remain affordable. In 2006, Related had two projects honored by the Urban Land Institute with its prestigious national Award of

Excellence: Time Warner Center, the iconic $1.6 billion mixed use development across from Central Park on Manhattan’s West Side, and Pueblo del Sol, the redevelopment of the troubled Aliso Village public housing project in LA’s Boyle Heights into a vibrant community of over 450 apartments and homes that we co-developed with McCormack Baron Salazar. Two worlds, indeed.

But I like to think these experiences have given me a unique perspective on real estate in California, not only on different markets but on the role public policies play in helping, or perhaps more frequently hindering, rational development in the state. And it is that subject I’d like to address with you today. Where are we today? Where are we headed? And, most importantly, what steps might be taken to improve the climate for development in California to bolster the State’s economy while responding to the needs of a still-growing population?

HOUSING MARKETS IN 2012

In preparing for this speech, I reviewed the avalanche of data sent to me, usually free of charge, over the internet. But I also talked to 10 or 15 friends of mine who are active leaders in homebuilding, apartment development, investment and finance in California and asked them the same questions I’m addressing today. Where do you see housing markets heading in California over the next 5-10 years, and why? What steps should be taken, by local, state or the federal government, to help address the State’s housing needs and investment climate?

Before launching in to any predictions, I’d like to explore the factors that weigh most heavily on California’s housing markets in 2012. Note that I used the plural “markets;” there are at least two Californias: Coastal California, which for the most part is in the process of recovering from the recession and, in a few spots like San Francisco and Silicon Valley, and parts of West Los Angeles/Santa Monica, and Inland California, which is still overbuilt and facing an uncertain future.

The job market: As we have heard, the job market continues to improve in California, albeit at a modest pace, and the unemployment rate is still well above the national average. Digging deeper, however, one finds that the unemployment rate for college graduates is under 5 % in most markets, but over 12% for those with just a high school degree and over 15% for those without a high school degree. Given the widely publicized challenges, budgetary and otherwise, facing the UC, Cal State and Community College systems, that should be raising red flags for our policymakers and indeed for the business community. California continues to be a leader in the knowledge based economy, and in tourism and entertainment. As a result, there is job growth at the upper end of the income spectrum and at the lower end, but the middle continues to suffer. Employment in the public sector has begun what I believe will be a long and steady decline, as ALL levels of government are forced to retrench, and employment in the construction industry and related trades, on which California was dependent to an unhealthy degree in the last cycle, is still way below pre-recession levels.

The foreclosure crisis: At a recent affordable housing conference I attended, there was much talk and gnashing of teeth about the foreclosure problem, and why affordable housing programs need to be deployed to help solve it. I completely disagree. There is a massive amount of capital, much of it from private equity funds, poised to invest in buying and renting foreclosed homes. According to a recent

article in Bloomberg, over $6 billion has been raised, but less than $2 billion spent. In reality, the number of foreclosed homes has dropped in most markets, bulk sales have been slow to materialize, and prices have begun to recover in some of the hardest hit markets, like Phoenix and South Florida. In addition, banks, prodded by the government, have begun to try to accommodate borrowers. My friend Mike Meyer, formerly the head real estate partner for Kenneth Leventhal in Orange County, who now runs a small fund active in the Inland Empire, told me that in the last three months, cap rates in their market have dropped from 8% to 6%, effectively raising prices by 25%. Because of all this activity, the distressed or "shadow" inventory is likely to be burned through in the next 18-24 months, resulting in a market price increase of at least 10%. In inland communities closer to jobs and transit, like Ontario, the first signs of new construction could emerge. But in exurban districts like Indio, in the Coachella Valley, a full recovery is likely years away.

Interest rates: As the press, which helped spook potential homebuyers by relentlessly flogging the downward spiral in home prices, starts to trumpet "the end of distress" and the return of multiple offers on homes in desirable locations, those buyers with reliable employment and and some down payment capacity will quickly return to the market. There is considerable evidence that this is already occurring, again in Coastal California. At the high end, Related has closed nearly $60 million in sales at our Century high rise condominium in 2012. And my friend Larry Webb's New Home Company has made 42 sales in six weeks, at an average sales price of $1.2- $1.3 million, at its Lambert Ranch development in Irvine. The lower end has been slower to move, principally because prospective home buyers with less than perfect credit continue to have difficulty qualifying for loans.

Demographics: It has become an article of faith in the apartment industry that demographics are driving rental demand and will continue to do so for the foreseeable future. This argument is fundamentally accurate.

--California's population is projected to increase by approximately 400,000 annually through 2025. Although there is evidence that existing residents continue to leave for other parts of the country, legal immigration (which I believe will slowly increase over the next decade) and high birth rates in California's immigrant communities, will result in a net increase. Among immigrants, 75% to 85% typically rent, at least initially.

--Between 1995 and 2005, between 5 and 7 million renters nationally became homeowners. Since then, especially in the past four years, that trend has reversed, and approximately 3.5 million of those owners have become renters again

--The population of 18- to 35-year olds, which is the core of rental demand, is at its highest point in decades. I know: I have three kids in that cohort….

--As demand has increased dramatically, new supply has dropped to historic lows. Over the past three years, new construction has averaged about 1/3 the level of the previous 15.

The investment community has taken notice. Apartment sales more than doubled from 2010 to 2011, and 2012 transaction volume to date is ahead of 2011.

As in the for sale market, low interest rates have been a major factor in this surge, and have fueled a major uptick in values. Examples abound:

--Last year, we sold our two apartment properties in Little Tokyo to at prices equivalent to a sub-4% cap rate on current NOI.

--In the last year, we have also sold two of our older tax credit properties at cap rates just over 6%, **even with 55 year restrictions on the below market rents.**

--Most new construction apartment projects in California, which are clustered in the San Diego, Los Angeles/Orange County, and San Francisco Bay areas, are hoping to achieve a 6 cap at stabilization and many, especially in the hottest submarkets, are more likely to achieve a 5 or 5.5, as land and construction costs continue to rise. If anyone shows you a pro forma with a stabilized return at 7 or greater, call me: I have a bridge to sell you.

One note of caution: Although their role in the for sale housing markets is far better known, the GSE's (Fannie Mae and Freddie Mac), play an equally significant role in providing liquidity (and sustaining values) in the market rate apartment market. We should all watch very carefully how Congress and the Administration deals with their future in the coming years.

A TALE OF TWO CITIES

Let me now move from the macro to the submarket level, and let us look at how these trends are playing out in two very active, but also very different, markets in which we are active, downtown Los Angeles and San Francisco.

As has been well documented, downtown Los Angeles rose from decades of slumber over the last 10 years. Staples Center, LA Live and Disney Concert Hall were built, and the residential population of downtown more than doubled. But then we got a little ahead of ourselves. Back in 2005, it seemed like every month, some developer no one had heard of before was announcing a 50 story condo tower. Having built at this scale before, we at Related competed for and won the rights to develop the Grand Avenue project on three city blocks near Disney Hall on Bunker Hill. Irrational exuberance? I plead guilty.

The recession put a stop to most of that activity, as it did virtually everywhere. But not all of it. Last year, over 100 restaurants, bars, clubs and stores opened in downtown LA alone. These will help provide the amenity and entertainment base that is essential to continued growth. And we quietly worked out a deal with Eli Broad to build a world class museum of modern art, to be paid for and endowed by him alone, on one of our sites. And while the financial markets slumbered, we oversaw the design and construction of a new 16 acre civic park, paid for by our land acquisition, which will open next month and be run by the Music Center.

But we never lost sight of the economic potential, and worked with our public agency partners to prepare for the next cycle. We negotiated a deal with the agency formerly known as the CRA, as I like to refer to it, to develop a 20 story mixed income apartment tower with 271 units and restaurant and retail space, adjacent to the new Broad museum, which will open onto a new public plaza funded by the CRA,

and being designed by Diller Scofidio, the firm that designed the museum. And we and Broad expect to announce a deal with a noted restaurant operator for two venues, one on the plaza and another in our building, later this year. Construction on our tower should start this fall.

What was to have been our first phase, the block directly opposite Disney Hall on Grand Avenue, which has been on hold, is now being replanned to better reflect the realities of the downtown market. It will still include a mix of hotel, residential, and retail space, but in a slightly less ambitious form. We expect to have a revised plan for discussion by the fall. Stay tuned.

That is hardly the only new activity downtown. There are an additional 2,000-2,500 units of housing under construction or in planning, significant retail activity, especially in the Figueroa corridor, and at least two new hotels moving forward. And this is all prior to the proposed new NFL stadium and convention center expansion.

But while I remain bullish on downtown, I leaven that with a healthy dose of reality and, hopefully, some perspective. We are building a high rise rental project in part because we are sharing parking costs with the Broad garage, and are receiving subsidies to help with our 20% affordable housing requirement. In order to justify new construction of a high rise (concrete) residential rental building elsewhere, assuming market land costs and no subsidies, rents would have to be in the $4.50 per square foot range. That might work in Century City or Santa Monica, but not in downtown. Similarly, to justify the construction of a new condominium tower, sales prices would have to exceed $800 or even $900 per square foot, depending on land and site costs. Units in AEG's Ritz Carlton Tower have sold in that range, but that, like our Grand Avenue hotel/condo proposal, is a unique animal. The office market, on the other hand, has been relatively static, with many rents in Class A buildings still below $30 per square foot NNN, well below the $45-$50 that would be required to justify new construction. The market's affordability relative to the west side offers an opportunity for at least some employment growth there in the near future, particularly as older buildings are repositioned to accommodate the new wave of tenants.

Assuming modest economic growth, rental increases of 3-4 % in apartments over the next 3 years are likely. Construction of new condominiums will follow, aided by the growing base of amenities which will begin to attract empty nesters as well as young move-up professionals and the already significant base of Asian buyers.

It is no longer a secret that San Francisco is the hottest real estate market in the country, fueled by explosive growth in established tech and social media firms. We are processing a 215 unit apartment project in the Potrero Hill neighborhood and working on a high rise mixed use site near the Transbay Terminal downtown, and have been active in the market for many years. Our average rents at the Paramount, a 10 year old building, exceed $4.20 psf, and our retail rents average over $20 psf. Further, most buildings are parked at ratios of less than 1:1, significantly reducing construction costs, and landlords can charge upwards of $250 per month for parking. (In LA, 1.25:1 would be a minimum threshold and each unit would typically get one space at no charge.). When we built the Paramount from 1999-2001, its south of Market St. location was considered pioneering. When we opened the building, rents averaged a little over $3 psf. By 2007, they had risen over $4 psf, only to drop to $3.35

two years later, before increasing again. It is worth noting that the ten year average annual increase in rent has been around 4.5 %, for those of you who follow such things. And office rents South of Market on average now exceed those in the more established North of Market financial district., a reality that would have been unthinkable even five years ago, exceeding $50 psf NNN and encouraging the construction of the first new office buildings in many years.

San Francisco's real estate markets stabilized a couple of years before those in LA. The rental increases occurring in LA now began two years ago in SF. Condo pricing also bottomed out 2-3 years ago, making SF one of the few markets nationally in which construction loans for new condo construction in select locations are available today. A small condo project on Valencia St. in the City's resurgent Mission District recently sold most of its units at prices over $900 psf; in LA, those values exist today only in select precincts on the west side and Santa Monica. The Bay Area also benefits from an extensive and effective system of mass transit, which has begun to create a seamless corridor for housing and jobs between SF and San Jose and, to a lesser extent, between SF and the East Bay. Policy makers in Southern California should take note.

Job growth in the City and neighboring Silicon Valley in technology, social media, and related fields, of course, has fueled this boom, which is occurring on a smaller scale in a swath of west LA from Playa Vista to Santa Monica. This January, we started construction on 158 luxury condos (and 160 affordable apts.) on three City-owned sites on Ocean Boulevard in Santa Monica. Despite lenders' understandable aversion to condos, we were able to obtain a $120 million construction loan from Wells Fargo and HSBC, at a loan to cost of 65%, due to the relative strength of this submarket and extreme barriers to entry for new product. Similarly, office rents are climbing well above $50 psf, encouraging new construction. In fact, Santa Monica "reads" like the SF Bay Area, enjoying strong job growth, good weather, and a challenging entitlement climate.

Will these trends continue?

All of this sounds like a reasonably encouraging story for real estate, at least in coastal California. People will always want to live here, and investors from around the globe, especially Asia, will always view California as a safe haven. We even have a championship team in HOCKEY! But are we planning for the growth that is actually occurring, or just putting our fingers in the wind and hoping things work out?

Consider the following issues, then ask yourself what, if anything, is being done to address them?

1. **Government budgets**: Almost two years ago, State Senate majority leader Darrell Steinberg stopped by my office and asked me if I had my druthers, what could the State do to help my business? No doubt expecting me to ask for regulatory relief or funding for affordable housing, he was surprised when I told him to focus first on fixing the State's budget. And that's only one level of the problem: I cannot recall a time in my professional life when EVERY level of government was so financially stressed. Apart from all the obvious problems this presents, why should we in real estate in particular care about it? For starters, someone has to pave the way for growth, by investing in infrastructure, transportation and education. Traditionally, state and local governments have funded these by borrowing in the tax-exempt markets. Today, because

of investor trepidation about the ability of many local governments to repay these obligations, tax-exempt interest rates remain 100 to 150 basis points above where by all rights they should be. This mind set has even infected tax-exempt borrowing for private purposes, such as multifamily housing, even though government agencies are merely conduits for issuing bonds in those cases. The taxable and tax-exempt markets have effectively inverted. So, in a vicious cycle, the resultant increase in interest expense further burdens already strapped government budgets. The result? Either projects that are necessary to accommodate growth are postponed, or governments turn elsewhere for help. And where do they inevitably turn? To us, in the development community. Remember fees of $40,000 and $50,000 a unit? Get used to them. And try providing "affordable" housing while you're at it.

2. **Environmental regulation**: I have a confession to make. Although I am a real estate developer, I don't reflexively oppose all regulation. Difficult entitlements? Less competition! And some regulation is necessary to protect us from ourselves….but we in California have gone way off the deep end…. Let's start with CEQA, the Calif. Environmental Quality Act. Someone, I believe it was Woody Allen, once described a "quadrisexual" as "someone who will do anything with anyone for a quarter…" (I know you're wondering where I'm going with this…). Well, under CEQA, anyone can challenge virtually any project on virtually any grounds for little more than a quarter. The Governor and several key legislators have indicated a desire to pursue CEQA reform, but "not this year…" So let me suggest what they should do as soon as they can get around to it:

a) **Time limits on legal challenges**: Similar to the legislation passed last year on behalf of AEG's proposed NFL stadium, CEQA plaintiffs should be limited to one bite at the apple; re-filing lawsuits on different issues should not be permitted.
b) **Limit standing to sue**: Standing to sue should be limited to those whose concerns are legitimately environmental. Currently, business competitors and others with an axe to grind against a particular project can hide behind an "unincorporated association." At a minimum, if the plaintiff is listed as "Friends of the Environment," it should be required to disclose exactly who that is.
c) **Limit scope of challenge to issues of direct impact**: Issues such as global warming and urban decay are, in reality, beyond the scope of any reasonable evaluation of virtually all projects. They have become tools to simply stop or delay projects, absent any other substantive argument.

3. **Affordable Housing:** As I have discussed**,** financing is readily available for new apartment construction in well located submarkets, and this will help accommodate growth in white collar employment in the state. But this is not the segment of the State's population in which most of the growth is projected to occur. Rather, most demographers predict that a high percentage of the State's population growth will come from minority communities. And with a stressed system of higher education to prepare young people for higher paying jobs, and continued growth in the lower paying tourism and service industries, there will be an increased demand for

affordable rental housing. With the demise of redevelopment, however, which typically provided between $1.0 and $1.5 billion annually for affordable housing development, and the virtual withdrawal of the federal government, there are few resources to pay for it. Whatever your feelings about governmental involvement in housing, let me appeal to your self interest. Absent more resources, proponents of affordable housing and some local governments will turn, again, to the development community, by imposing so-called inclusionary zoning requirements, in which developers of new housing must either build or help pay for affordable units.

Even with the state's budgetary problems, however, there are alternatives. And what I am about to propose will disappoint both affordable housing activists as well as elements of the realtor and homebuilding industries, so I think I'm on to something viable….First, while I do not believe that strict inclusionary zoning programs, in which every building of greater than 20 units or so must include or pay for affordable units, are workable in most cities (San Francisco may be an exception), and they absolutely can't work without a pro-growth planning and land use environment, I do support reasonable inclusionary requirements in master planned communities. It is not plausible to argue that a 300 acre community requesting discretionary zoning approvals which will exponentially increase value can't set aside 10 or 15% of the to-be-built housing units for lower income households. This has been done successfully throughout areas as diverse as San Diego County and the Bay Area, and should be encouraged. Second, the state should enact a version of SB 1220, a bill which nearly passed the legislature in this session which would create a permanent source of funding for affordable housing by charging a $75 document recording fee on real estate transfers. Fees as well as taxes require a 2/3 vote of approval, however, and it fell two votes short of passage.

4. **Redevelopment:** Redevelopment as we have known it is dead and it ain't coming back any time soon, at least in a recognizable form. But is this really a problem for the real estate industry? At a macro level, not so much. Market rate housing and commercial development will continue to occur subject to market conditions, and most developers won't notice, or perhaps avoided redevelopment areas in the first place. The problem is the type of development that won't happen. Let me explain this by example. It can be argued that the Mission Bay neighborhood in San Francisco, once 300 acres of unused rail yards, has been the engine that has fueled that City's recent growth. It is today home to a new campus for the UCSF Medical Center and the state's most vibrant biotechnology sector, thousands of units of new, high density housing, of which 30% is affordable, a new light rail line, and adjacent to the new Giants baseball stadium. As UCLA's own Nelson Rising, who oversaw much of this development as CEO of Catellus Development Co., has eloquently described, none of this would have occurred without the use of tax increment financing to fund infrastructure and environmental improvements. The payoff to local government in sales, property and payroll taxes alone has been phenomenal. By contrast, Moffett Field, 70 acres of mostly raw land owned by NASA just east of the 101 Freeway near Mountain View in Silicon Valley, the largest piece of undeveloped land between SF and San Jose, continues to lie fallow, even in today's overheated environment. Planned for 1900 units of high density housing and a couple million feet of office and R & D space, and adjacent to the site where Google is building its world headquarters, it is also a Superfund site and lacking in any

basic infrastructure. I understand the challenge because, three years ago, Related and TMG Partners of SF were selected by a University consortium that had leased the property from NASA to act as master developers of the site. The magnitude of the required investment in remediation and infrastructure, however, was too great to encourage private investment without some front end public investment. These are potentially transformational projects, that can help California retain its competitive edge in the health and technology sectors.

I have long stated that redevelopment, or government involvement in general, should only take place for three purposes: 1) affordable housing; 2) infrastructure and environmental remediation; and 3) assistance to communities with high rates of poverty. In each case, the proposed activity cannot, almost by definition, be addressed by the private sector alone. The problem in California, even before the recent budget skirmishes, was that redevelopment had become an entitlement. Almost every community, from Compton to Mission Viejo, had a redevelopment agency, and property tax dollars were often used by one community to lure economic activity from another. Clearly, nothing of consequence will occur in Sacramento this year, absent resolution of the state budget crisis. But policymakers need to find a means of leveraging opportunities like these, wherever they may exist.

5. **Planning for growth:** In recent years, there has been a flurry of activity, mostly at the State level, in support of what policymakers like to call Smart Growth. SB 375, authored by Senator Steinberg, actually attempts to steer growth to prevent sprawl, encourage public transit, and encourage the siting of housing near jobs. But nothing is ever easy in California. There is still a large divide in this state on the issues of density and growth.

   Representing a common refrain, The author and analyst Joel Kotkin, to whom the LA Times always turns when it wants a quote from someone who is a smart growth skeptic, recently fretted that advocating density is like consigning people to live “like my grandmother did in Brownsville,” referring to an inner city neighborhood in Brooklyn. I found that analogy a tad overwrought, but most families, he argues, want a single family home with a yard, and efforts to thwart that goal are doomed to fail. And the California League of Cities, representing local elected officials, while supportive of smart growth in general, tends to oppose ANY efforts by the State to intervene in what it believes should be local land use decisions. These debates continue in Committee meeting rooms and academic institutions.

   In the mean time, we fail to accommodate our growing population. My colleague Tony Salazar, a successful developer in his own right, who lives in Whittier, a working- and middle class city that is now predominantly Hispanic, told me that in his community of mostly single family homes (and many others like it), young families are increasingly leaving the state, while others live in garages. There are few alternatives. His point: if current land use patterns of low density persist, we are headed for a cliff. The other side of this coin is that we are likely to experience a return in 5-7 years to a housing market unaffordable to the majority of Californians, a “re-run” of an old California standard.

That said, California has always relied on the real estate industry to spur economic growth. Our industry creates thousands of jobs and revitalizes neighborhoods. We can choose to sit by and watch our partners in government struggle with the challenges of the day or we can embrace our collective responsibility to help formulate creative solutions.

One last thought: Since this is in fact an economic forecasting conference, and in the spirit of last year's speaker, Sam Zell,(who famously in 1990 said "Survive till '95," and three years ago, "Come clean in 2013), I offer the following simplistic prognostication. "Hang in there till '20, and you will make plenty…"

I want to thank the Ziman Center for the opportunity to speak with you today.