

# Casden Industrial and Office Market Forecast Shaking Your Thinking About Commercial Real Estate

December 7, 2010



**University of Southern California**  
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# **2010 Casden Industrial and Office Market Forecast**

## **Shaking Your Thinking About Commercial Real Estate**

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### **HOT TOPICS**

**KEVIN MAGGIACOMO, PRESIDENT & CEO, SPERRY VAN NESS INTERNATIONAL**

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### **2010 CASDEN INDUSTRIAL AND OFFICE MARKET FORECAST**

**TRACEY SESLEN, SENIOR RESEARCH ASSOCIATE**

**USC CASDEN REAL ESTATE ECONOMICS FORECAST**

### **PANEL DISCUSSION**

**MODERATOR: BURLAND EAST, CHIEF EXECUTIVE OFFICER**

**AMERICAN ASSETS INVESTMENT MANAGEMENT, LLC**

### **PANEL MEMBERS:**

**STANLEY L. IEZMAN, CHAIRMAN AND CHIEF EXECUTIVE OFFICER**

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**TERRI RIKER, COURT-APPOINTED RECEIVER, SENIOR VICE PRESIDENT - PORTFOLIO MANAGER**

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### **CLOSING REMARKS**

**RICHARD GREEN, DIRECTOR, USC LUSK CENTER FOR REAL ESTATE**

## Report Authors

**RICHARD K. GREEN** | Director of the USC Lusk Center for Real Estate

Richard K. Green, Ph.D., is the Director of the USC Lusk Center for Real Estate. He holds the Lusk Chair in Real Estate and is Professor in the School of Policy, Planning, and Development and the Marshall School of Business.

Prior to joining the USC faculty, Dr. Green spent four years as the Oliver T. Carr, Jr., Chair of Real Estate Finance at The George Washington University School of Business. He was Director of the Center for Washington Area Studies and the Center for Real Estate and Urban Studies at that institution. Dr. Green also taught real estate finance and economics courses for 12 years at the University of Wisconsin-Madison, where he was Wangard Faculty Scholar and Chair of Real Estate and Urban Land Economics. He also has been principal economist and director of financial strategy and policy analysis at Freddie Mac. More recently, he was a visiting professor of real estate at the University of Pennsylvania's Wharton School, and he continues to retain an affiliation with Wharton. He is or has been involved with the Lincoln Institute of Land Policy, the Conference of Business Economists, the Center for Urban Land Economics Research, and the National Association of Industrial and Office Properties. Dr. Green also is a Weimer Fellow at the Homer Hoyt Institute, and a member of the faculty of the Selden Institute for Advanced Studies in Real Estate. He was recently President of the American Real Estate and Urban Economics Association.

Dr. Green earned his Ph.D. and M.S. in economics from the University of Wisconsin-Madison. He earned his A.B. in economics from Harvard University.

His research addresses housing markets, housing policy, tax policy, transportation, mortgage finance and urban growth. He is a member of two academic journal editorial boards, and a reviewer for several others. His work is published in a number of journals including the American Economic Review, Journal of Economic Perspectives, Journal of Real Estate Finance and Economics, Journal of Urban Economics, Land Economics, Regional Science and Urban Economics, Real Estate Economics, Housing Policy Debate, Journal of Housing Economics, and Urban Studies. His book with Stephen Malpezzi, A Primer on U.S. Housing Markets and Housing Policy, is used at universities throughout the country. His work has been cited or he has been quoted in the New York Times, The Wall Street Journal, The Washington Post, the Christian Science Monitor, the Los Angeles Times, Newsweek and the Economist, as well as other outlets. He recently gave a presentation at the 31st annual Federal Reserve Bank of Kansas City Economic Symposium, where his work was cited by Federal Reserve Chairman Ben Bernanke. The National Association of REALTORS, the Ford Foundation, and the Lincoln Institute for Land Policy have funded grants to support some of Dr. Green's research. He consults for the World Bank.

In 1995, Dr. Green was honored as "Teacher of the Year" by the University of Wisconsin Graduate Business Association, and soon thereafter was inducted into that University's Teaching Academy.

**TRACEY SESLEN** | Senior Research Associate, USC Casden Real Estate Economics Forecast

Tracey Seslen received her Ph.D. in Economics from the Massachusetts Institute of Technology in 2003 and has been an Assistant Professor of Clinical Finance and Business Economics since 2006. She currently teaches Real Estate Finance in the Marshall School of Business and the School of Policy, Planning, and Development at USC. She is also one of the core finance instructors for the Ross Minority Program in Real Estate. Her past research has focused on housing cycles, the capitalization of risk and return into housing prices, household mobility behavior, and termination risk in commercial mortgages.

For the past year, she has been the co-author of the Casden Real Estate Report and in that role has developed new models for predicting price and vacancy movements for office, industrial and multi-family markets in Southern California. Her expertise in real estate finance has led to quotes in the LA Times, Wall Street Journal, OC Register, LA Business Journal, Long Beach Business Journal, California Real Estate Journal, SmartMoney.com, Downtown News, and other local and national publications. In addition, she has appeared on the Today Show, Marketplace Radio, and various local network news broadcasts. Recently, she has worked as an expert witness on real estate valuation issues.

When not working in the field of real estate, she is an avid international traveler, photographer, and skier. She lives in Marina del Rey with her husband and 2-year-old daughter.

**J.C. CASILLAS** | Assistant Vice President, Client Services Manager, Grubb & Ellis Company

Mr. Casillas has been with Grubb & Ellis since 1998. He is responsible for the management of the firm's Southern California research and marketing operations, overseeing extensive data collection, verification, tracking and analysis of the Southern California market. As part of the Southern California management team, Mr. Casillas works extensively with brokers on business development projects, client presentations and special research assignments. Mr. Casillas' market information and analysis are featured every quarter in the Commercial Real Estate update published by the Los Angeles Business Journal. He is recognized by various organizations and universities, including the Los Angeles County Economic Development Corporation (LAEDC), the San Fernando Valley Economic Research Center, and the Real Estate Research Council of Southern California as the "go-to" person for real estate market information. Mr. Casillas received a Bachelor of Science from USC majoring in Public Policy and Management with a minor in Business.

**JASMIN VARJAVAND** | University of Southern California, Class of 2011

Jasmin Varjavand is a senior at USC, majoring in real estate development at the School of Policy, Planning and Development and minoring in business at the Marshall School of Business. She has had a strong interest in her real estate law and real estate finance courses. Jasmin is the founder and President of the USC Zoroastrian Group, a member of the Trojan Real Estate Association, and a part of Alpha Lambda Delta Honor Society. While attending USC, Jasmin has maintained high academic standards in addition to participating in many research and internship opportunities. As a freshman, Jasmin conducted research on affordable housing for the Director of USC's Master of Real Estate Development program. As a sophomore, she interned for the USC Real Estate and Asset Management Department. The Director of the USC Lusk Center for Real Estate nominated Jasmin to receive the first ever ICSC Foundation Undergraduate Real Estate Award in 2009. In spring 2010, Jasmin attended the USC Semester in Washington Program at GWU with a scholarship from the USC Club of the Nation's Capital. During this time, she volunteered at the Office of Policy Development and Research (PD&R) at the U.S. Department of Housing and Urban Development. The Assistant Secretary of PD&R promoted her from a student volunteer to a full-time intern at HUD for summer 2010. Jasmin now serves as a HUD Student Ambassador at USC. Most recently, Jasmin interned with Caruso Affiliated in Los Angeles, California.

**SKYE TIRSBIER** | MBA/MPL Dual Degree Candidate, Class of 2011, University of Southern California

Skye Tirsbier is a Master of Business Administration/Master of Planning dual degree candidate at USC. Before attending USC, she worked for New Urban West in Santa Monica for several years as the Entitlements Project Manager. Skye managed the entitlement process and secured approvals for a large mixed-use community in Southern California. Her academic honors include selection as a Marshall MBA Fellow and placement on the graduate Dean's List of the Marshall School of Business. After graduation, Skye is interested in either working for a redevelopment agency or returning to the private sector and working for a real estate development firm in Southern California.

## Speakers

### **KEVIN MAGGIACOMO** | President & Chief Executive Officer, Sperry Van Ness International

Kevin Maggiacomo serves as President & Chief Executive Officer of Sperry Van Ness International, and is responsible for the company's mission, vision, and day-to-day operation. Facilitating the company's expansion across the United States and beyond, Maggiacomo has facilitated Sperry Van Ness' growth from seven cities in 2001, to more than 150 today. During his 10 year tenure leading various facets of the organization, Sperry Van Ness has won numerous awards including being named one of the Most Innovative Brokerage Firms in North America by Realcomm, named in Inc. Magazine's list of the Fastest Growing Private Companies in America, and acknowledged by the Lipsey Co. as one of the most recognized brands in commercial real estate.

With 16 years of commercial real estate experience, Maggiacomo formerly served Sperry Van Ness as a regional director, executive vice president, its chief operating officer, and as national director of hospitality. Prior to joining Sperry Van Ness, Maggiacomo served as an advisor for RTE Group, Inc. a telecommunications real estate advisory group. While with RTE, Maggiacomo was responsible for the acquisition and disposition of data centers, web hosting centers and other real estate investment vehicles. Previously, he spearheaded New England sales efforts for CoStar Group, Inc. where he was consistently among the top national producers, earning President's Club honors in 1999. Maggiacomo also spent three years at CRESA Partners (formerly Avalon Partners), one of the nation's largest tenant representation brokerage firms, where he focused on providing corporate real estate services to entities including Lotus Development Corporation, EMC Corporation, and the US Postal Service, among others.

In 2010, citing his forward thinking commercial real estate vision, Maggiacomo was named to OC Metro's "40 Under 40" list. He is also a member of Young Presidents' Organization (YPO), and Vistage, two international chief executive think tanks. He serves as a board member and director with Real Leaders, a "B-Corporation," whose mission is to use the power of business to solve social and environmental problems. In addition, Maggiacomo serves as an alumni career representative for Providence College, where he earned a Bachelor of Arts degree.

### **GABRIEL MARQUEZ** | Partner, Ernst & Young

A partner in Ernst & Young's Real Estate, Hospitality and Construction (RHC) practice in Los Angeles, California, Gabriel has over 21 years of experience serving a variety of private and publicly held real estate and construction companies, including opportunity funds, real estate partnerships, owners/developers, engineering firms and contractors. Gabriel has extensive experience in GAAP technical matters, Sarbanes-Oxley Act of 2002 and SEC experience with both 1933 and 1934 Act Filings, and serves as a firm subject matter expert on contract accounting matters. Additionally, Gabriel has lead various client special projects ranging from land development/ construction cost and operational audits, contract claims resolution, mergers & acquisitions, and restructurings / reorganizations.

Gabriel serves as an Executive Sponsor for Ernst & Young's West Sub-Area Latino Professional Network, Inclusiveness & Flexibility Champion for the Real Estate, Hospitality and Construction industry sector, and Campus Recruiting Diversity Champion at UCLA.

Gabriel has served as a National and Los Angeles Chapter Director for the Construction Financial Management Association (CFMA), is a Corporate Advisory Board member for the Association of Latino Professionals in Finance and Accounting (ALPFA), and has authored several industry related articles. He is a graduate of UCLA, and is a member of the American Institute of CPAs (AICPA) and California Society of CPAs.

**BURLAND EAST** | Chief Executive Officer, American Assets Investment Management, LLC

Mr. East joined American Assets Investment Management as Chief Executive Officer in October of 2010 after spending close to 30 years as a Wall Street securities analyst and investment banker.

He previously co-owned and was a managing principal of Silver Portal Capital, an investment bank specializing in large-scale institutional real estate transactions. In that capacity he raised approximately \$1.6 billion in equity for platform-level real estate operators with the largest investors in the US: including CalPERs, CalSTRS, State of Michigan, Utah Retirement, NYSTRs, Morgan Stanley, JP Morgan as well as dozens of others and completed seven large advisory transactions totaling \$2.2B for private and public clients including entity level recapitalizations, mergers and public listings.

Prior to Silver Portal, Mr. East was a Managing Director and was Co-Head of Real Estate Securities and Head of Real Estate Securities Research at Wachovia Securities and its predecessor firms from 1992 to 2001. During his career he has completed 142 large-scale real estate transactions including; 26 REIT IPOs, 40 REIT follow-on offerings, 19 private equity transactions as well as numerous converts, preferred stocks, bond offerings, tenders, mergers, strategic advisory assignments and mezzanine debt placements.

Mr. East has published approximately 20,000 pages of widely distributed equity research and has domain experience in retail, multi-family, office, industrial, lodging and leisure, healthcare and medical, senior housing, land, gaming and homebuilding. He was awarded Dow Jones/Realty Stock Review outstanding sell side analyst, honorable mention in 1996, 1997 and 1998.

Mr. East graduated with an MBA from Loyola College in Md. in 1984 and is a Chartered Financial Analyst (CFA). He holds the following FINRA licenses: Series 24 – General Securities Principal, Series 27 – Financial Operations Principal, Series 7- Registered Representative, Series 63 – State Blue Sky.

**STANLEY L. IEZMAN** | Chairman and Chief Executive Officer, American Realty Advisors

Mr. Iezman is responsible for the strategic planning and direction of American Realty Advisors, an SEC registered investment advisor and ERISA fiduciary for tax-exempt investors. American currently has over \$3.5\* billion of assets under management, utilizing core, enhanced core and value-added strategies. American offers Separate Accounts, open-end and closed-end commingled funds to its pension fund investors. Mr. Iezman has directed the acquisition, structuring and management of approximately \$8 billion of real estate located throughout the United States. He is a member of the Executive Committee of the USC Lusk Center for Real Estate and an Adjunct Professor at the University of Southern California's School of Planning, Policy, and Development where he teaches real estate asset management in the Master of Real Estate Development Program. A noted speaker in the real estate arena, he has addressed a number of industry groups, and has authored numerous articles for real estate, pension, and legal industry publications. Mr. Iezman received his BA from the University of California-Santa Barbara and his JD from the University of Southern California School of Law. He is a member of The Urban Land Institute and serves on their Industrial & Office Park Development Council; International Council of Shopping Centers; National Association of Real Estate Investment Managers; Pension Real Estate Association; International Foundation of Employee Benefit Plans; Los Angeles County Bar Association; American Bar Association; and was the Chair of the New York University Real Estate Institute's Annual "Conference on Pension Fund Investment in Real Estate" for ten years.

\*Assets under management represent gross value of all assets and accounts managed by American as of September 30, 2010 (excluding partners' share of equity and partners' share of debt on partnership investments).

**GARY P. PALMER** | Managing Principal, Westbrook Partners

In July 2005, Gary P. Palmer joined Westbrook Partners as a Managing Principal and established Westbrook's San Francisco office. Mr. Palmer leads Westbrook's acquisition, value enhancement and realization activities in the western United States. He is a member of the Firm's Investment Committee.

Prior to joining Westbrook, Mr. Palmer spent 12 years at Morgan Stanley, serving most recently as an Executive Director in Morgan Stanley's San Francisco office, where he was Head of the Western Region for the Morgan Stanley Real Estate Group.

Mr. Palmer received a B.S., magna cum laude, in 1985 from the University of Southern California and a M.B.A. in 1990 from Harvard Business School.

**TERRI RIKER** | Senior Vice President – Portfolio Manager, Grubb & Ellis Management Services, Inc.

As Senior Vice President, Portfolio Manager for Grubb & Ellis Management Services, Ms. Riker brings over 25 years of experience in financial, operational and leasing oversight of commercial real estate portfolios. In a fiduciary capacity, Ms. Riker currently serves as a court-appointed Receiver for several rents, issues and profit cases, involving both direct and securitized commercial real estate loans throughout Southern California.

Ms. Riker has extensive experience in asset/portfolio management, transactional due diligence, acquisitions and dispositions throughout the U.S. She has held senior management positions, overseeing institutional real estate portfolios, for CalPERS, Catellus Development (Prologis), CBRE and HCP, Inc. Her expertise encompasses all product types, and investment structures (debt & equity), through all phases of the real estate life cycle. She has successfully transferred the management and operations of nationwide commercial property portfolios, established internal financial controls, audit and operational standards and handled a variety of work-outs and dispositions of underperforming assets.

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## Office Market Forecast

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After a dismal 2009, the Southern California office market showed little improvement in 2010. We expect rents in all three major markets to continue to decline over the next 18 to 24 months. The vacancy rate appears to have peaked already in Orange County, as well as in the Inland Empire for both Class A and Class B properties; however, it is so far above “natural” levels that it may continue to fall for many months to come without any accompanying stabilization in rents. The vacancy rate in Los Angeles County has been rising since Q3 2007 and will continue to do so for at least another year. The Class A sector may not see stabilization in occupancy rates until the first half of 2012. Overall, the future health of the office market will be dependent on several conditions:

**The employment picture.** Office space is made to be filled with workers. The fewer the number of workers that are needed in office-based industries, the more the office market will suffer. Southern California has outpaced California and the US as a whole in job losses over the last three years, with Riverside and San Bernardino counties topping the region at 15.3 percent and 14.2 percent unemployment, respectively. If GDP growth isn’t sufficient to create jobs, the office market will continue to languish.

“Natural” vacancy is the vacancy rate the market adjusts to in the long-term, or when supply and demand are in balance.

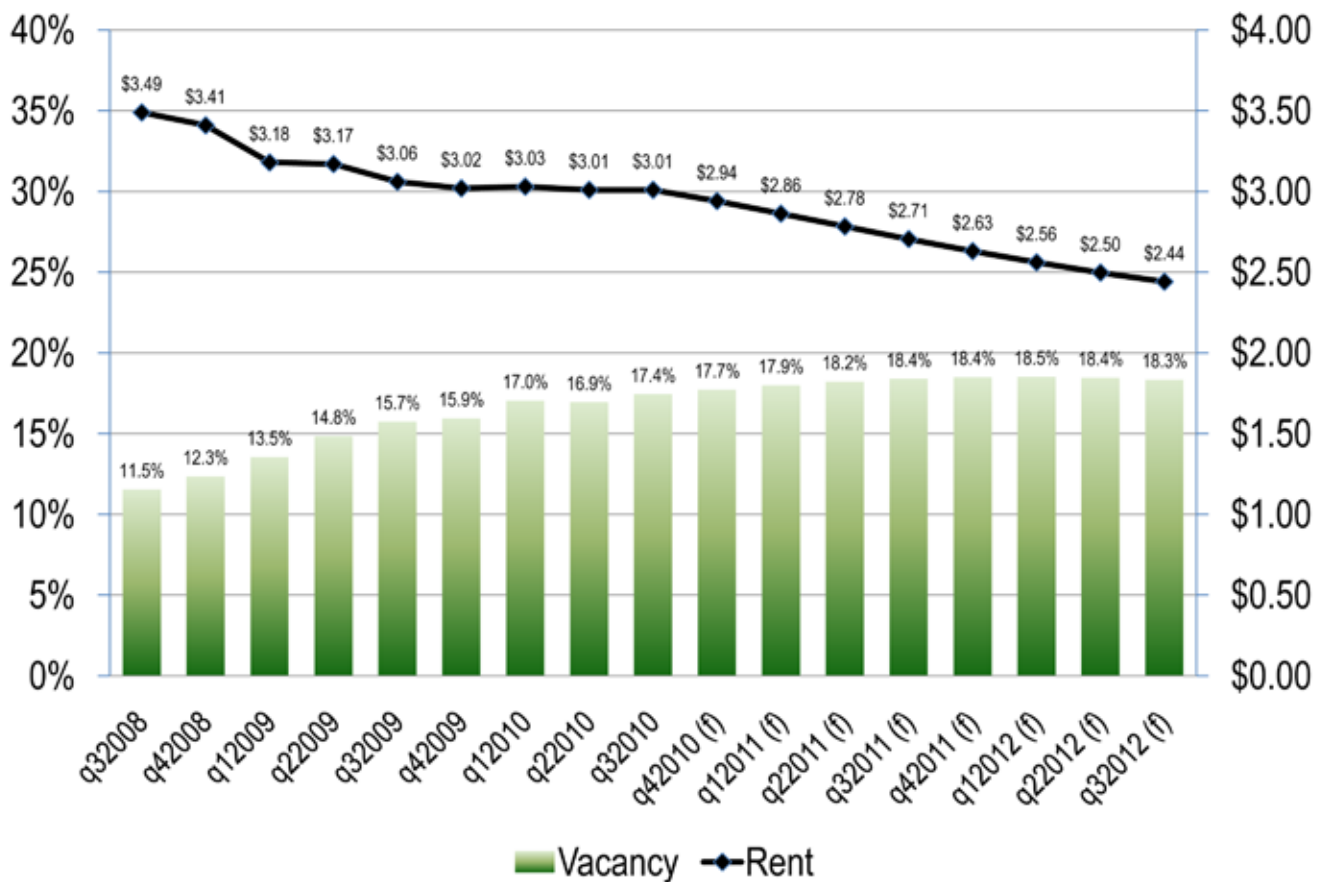
**Changes in corporate use of office space.** In order to cut costs in these difficult times, companies have become more efficient in their use of office space. Open floor-plans filled with cubicles have replaced the structurally partitioned offices of the past; temporary, hotel-based workspaces for executive road-warriors have replaced permanent, dedicated office space; and telecommuting from a home-based office has become increasingly commonplace. With less office space required per worker, the market needs to do more than replace the office jobs that have been lost; it needs to produce levels of employment above the previous peak to bring the office market back to health.

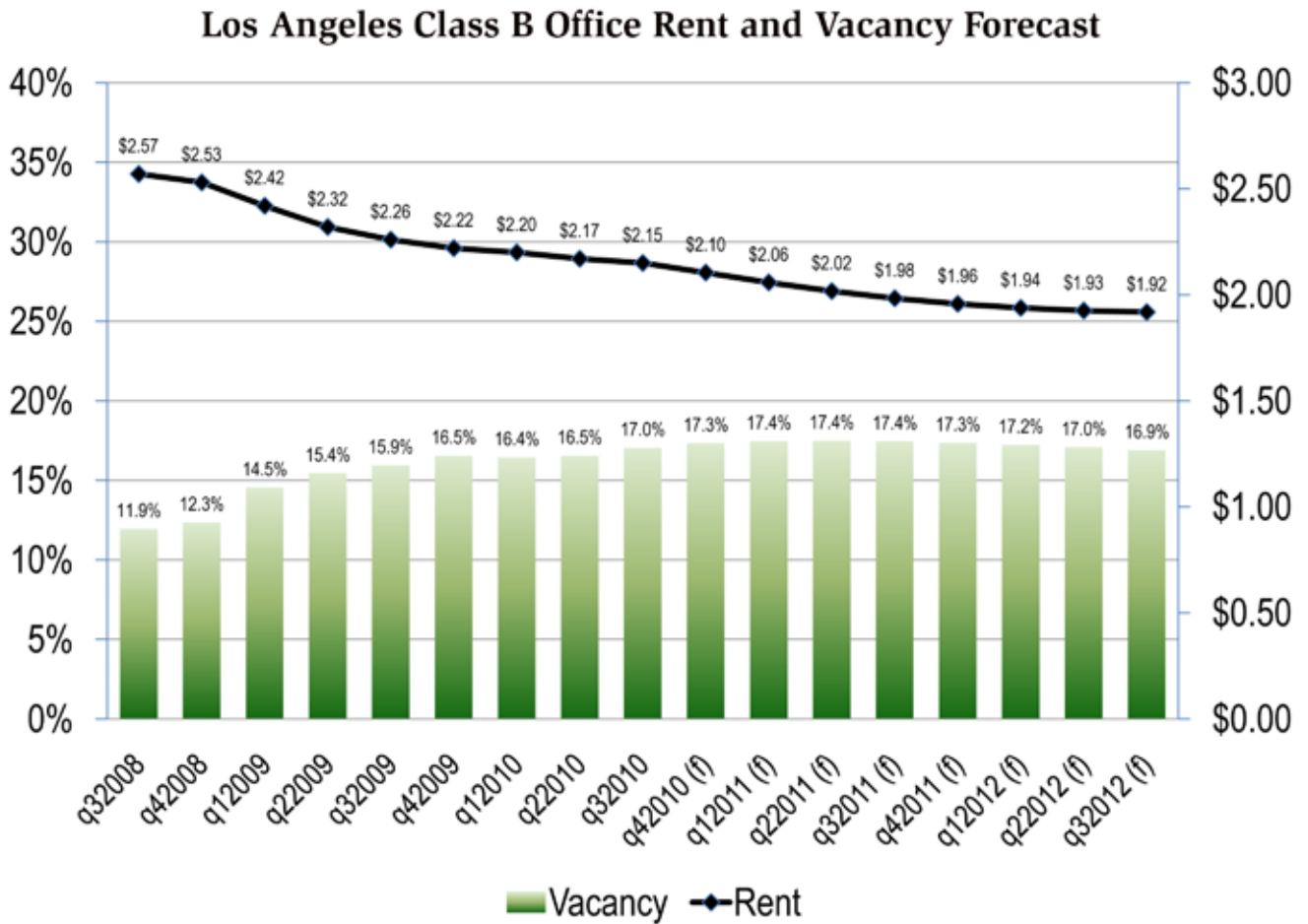
**“Green” considerations.** In recent years, there has been increased interest among tenants in making their companies more “green” – for instance, leasing office space in LEED Certified buildings, or locating in transit-oriented districts which allow employees to commute to work by rail, bus, or bicycle. With this in mind, in coming years, the better-performing sub-markets of Southern California are likely to be the ones that conform to this desire for “greenification”. Sub-markets with a higher share of LEED Certified buildings (or buildings that can be inexpensively retrofitted) and sub-markets with more green transportation options may recover sooner than ones with higher shares of older, energy-inefficient buildings in more automobile-dominated locations.

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In summary, the interplay of these three factors will help guide the future path of rents and vacancy in the office market. Southern California will not see increases in rents until the greater economic health of the area improves and some of the slackness in the market disappears. Currently, the three markets covered in this report are all 7 to 13 percentage points above their “natural” vacancy rate. On the Class A front, Los Angeles is expected to experience the highest rent declines and the Inland Empire the smallest. Among Class B properties, we forecast the Inland Empire to experience the highest rent declines and Los Angeles the smallest. We expect vacancy rates to decline significantly in Orange County in both property classes, and we expect to see them rise slightly in Los Angeles County.

**Los Angeles Class A Office Rent and Vacancy Forecast**

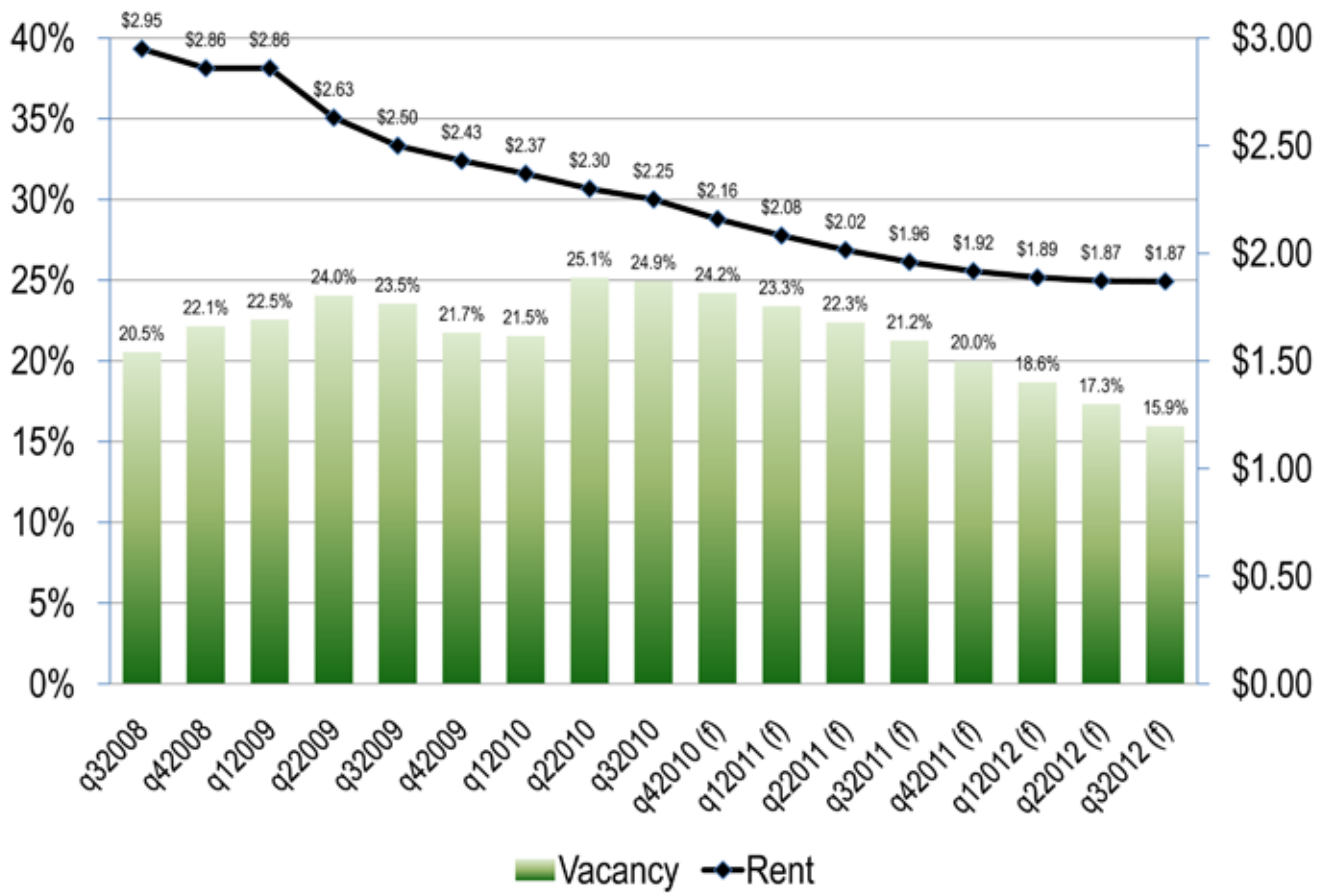


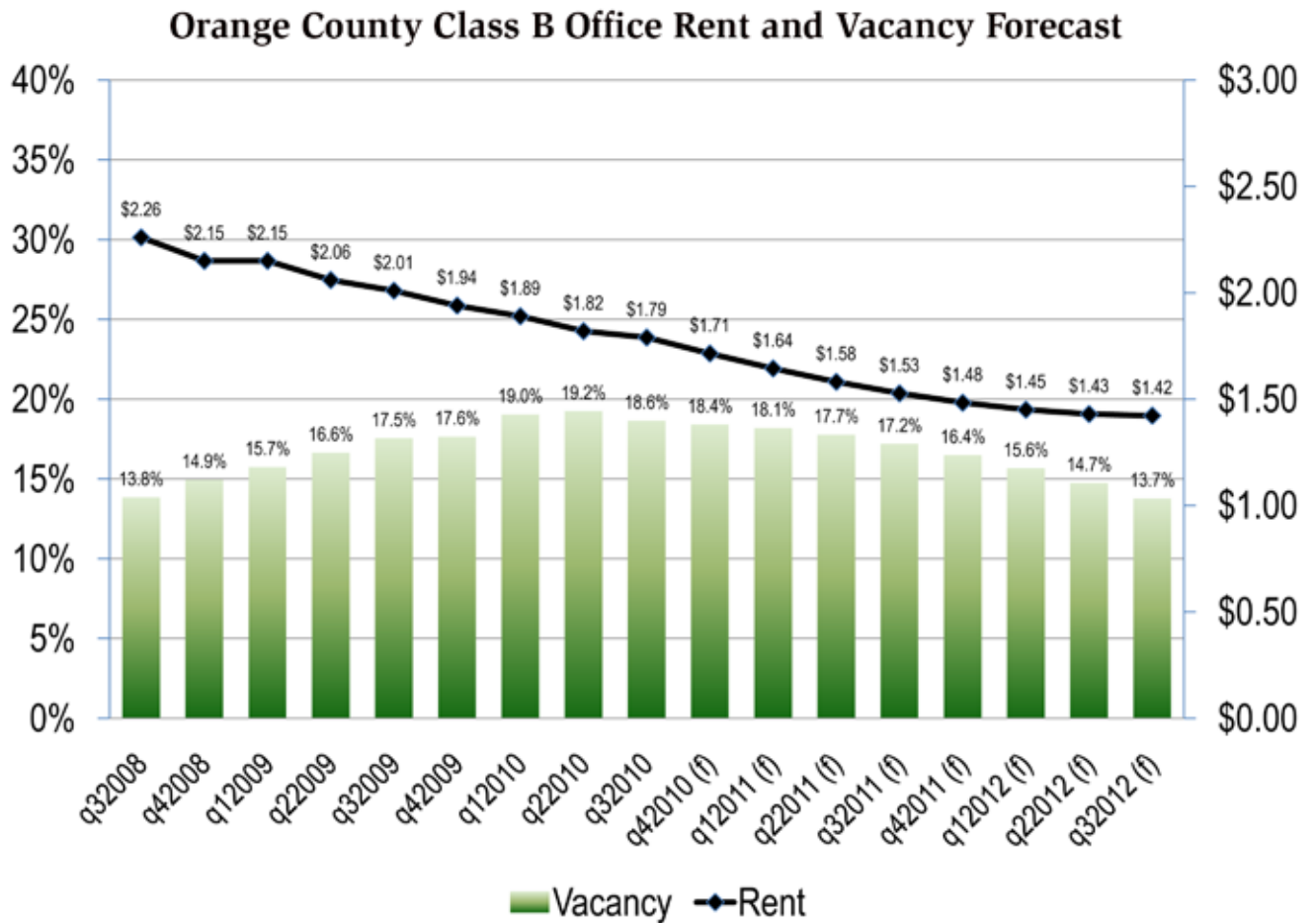


## Los Angeles Forecast

We expect vacancy rates in Los Angeles County to increase slightly, while rents continue to decrease. We expect Class A rents to decline an additional 10 percent over the next 4 quarters and 18.9 percent total over the next two years. We expect Class B rents to decline an additional 7.7 percent over the next 4 quarters and 10.7 percent total over the next two years.

## Orange County Class A Office Rent and Vacancy Forecast

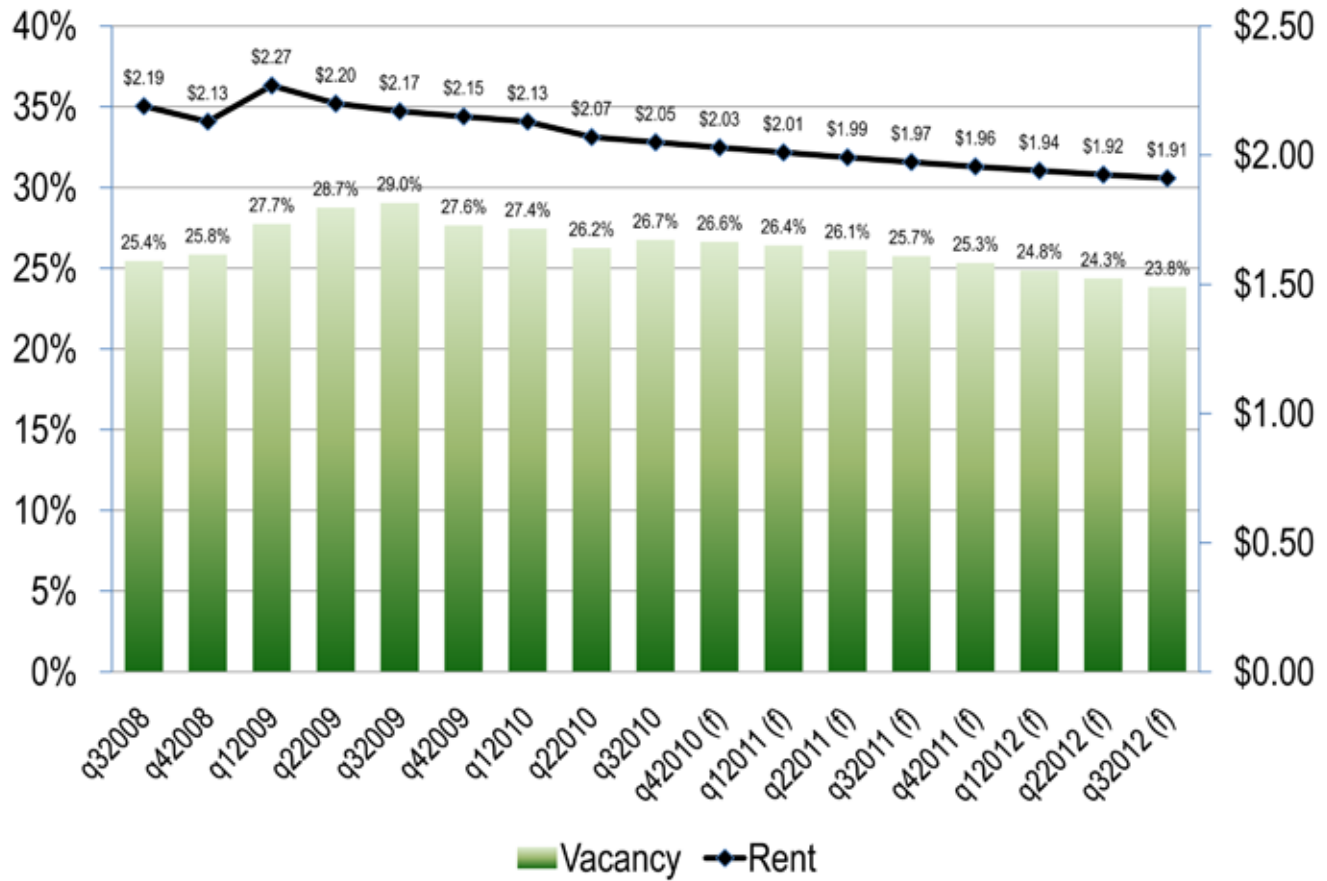


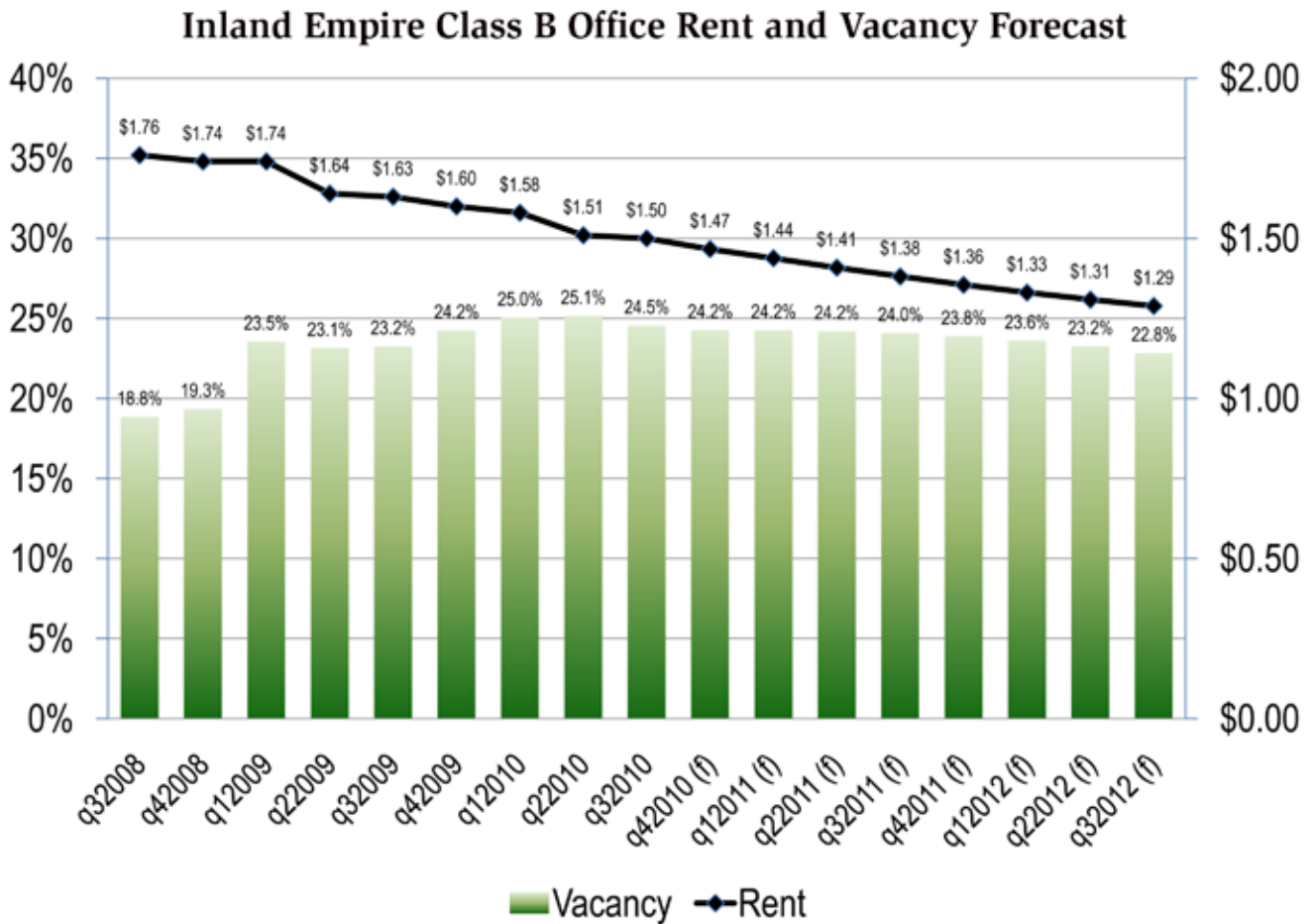


## Orange County Forecast

Our model predicts a significant decline in vacancy coupled with further decreasing rents. We expect Class A rents to decline another 12.9 percent over the next four quarters and 17 percent total over the next two years. Class B rents are expected to decline 10.3 percent over the next four quarters and 12.4 percent total over the next two years. The vacancy rate in Class A properties is expected to decrease by 9 percentage points from the current level of 24.9 percent over the next two years, while the vacancy rate in Class B properties is expected to decrease by 5.6 percentage points from its current level of 18.6 percent.

## Inland Empire Class A Office Rent and Vacancy Forecast





## Inland Empire Forecast

We anticipate a moderate decline in rents coupled with a small decline in vacancy in the Inland Empire over the next two years. Our forecast predicts that Class B properties, which make up the majority of the office stock, will see rents decline by an average of 7.9 percent average over the next four quarters and a 14 percent total over the next two years. The vacancy rate is expected to decrease by 1.7 percentage points over the next two years from its current level of 24.5 percent. We predict that Class A properties, which make up 35 percent of the office stock in the region, will see rents decline by an average of 3.7 percent over the next four quarters and a 6.8 percent total decline over the next two years. The vacancy rate is expected to decline by 2.9 percentage points over the next two years from its current level of 26.7 percent.

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## Industrial Market Forecast

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Relative to the Southern California office market, the industrial sector fared relatively well from Q3 2009 to Q3 2010. While all metro areas experienced declines in rents, Los Angeles and the Inland Empire saw increases in the demand for space. As with the office market, we will not see a sustained recovery until we see an improvement in the overall economic health of the Southern California region. More specifically, the future path of rents and vacancy in the industrial sector will be largely determined by the following four factors:

**Manufacturing output.** With the rise in unemployment and the de-leveraging of the American household, demand for consumer goods has declined, and along with it, manufacturing activity. This has led to a decline in general industrial space used for manufacturing processes as well as warehousing space used to store raw materials as well as finished products. As employment levels increase and consumer spending picks up, demand for industrial space will increase and rents will rise. Los Angeles is the largest manufacturing center in the United States, so changes in manufacturing output will have a greater influence on the demand for industrial space there than in areas in which manufacturing is less of an economic driver. Also, because vacancy rates in LA county are so low, a relatively small increase in demand should boost rents.

**Trade activity.** Los Angeles is the second largest industrial market in the nation and one of the tightest due to its position as the home of the nation's largest port. Industrial space in the vicinity of the port is used as temporary storage for both inbound and outbound containers. As shipping picks up (in either direction), so will demand for industrial space. Areas in close proximity to the port will benefit more from increased trade activity than those further off the main arteries from the port area, all else equal. Port traffic through October 2010 stood at 6.5 million containers, up 16.9 percent from last year.

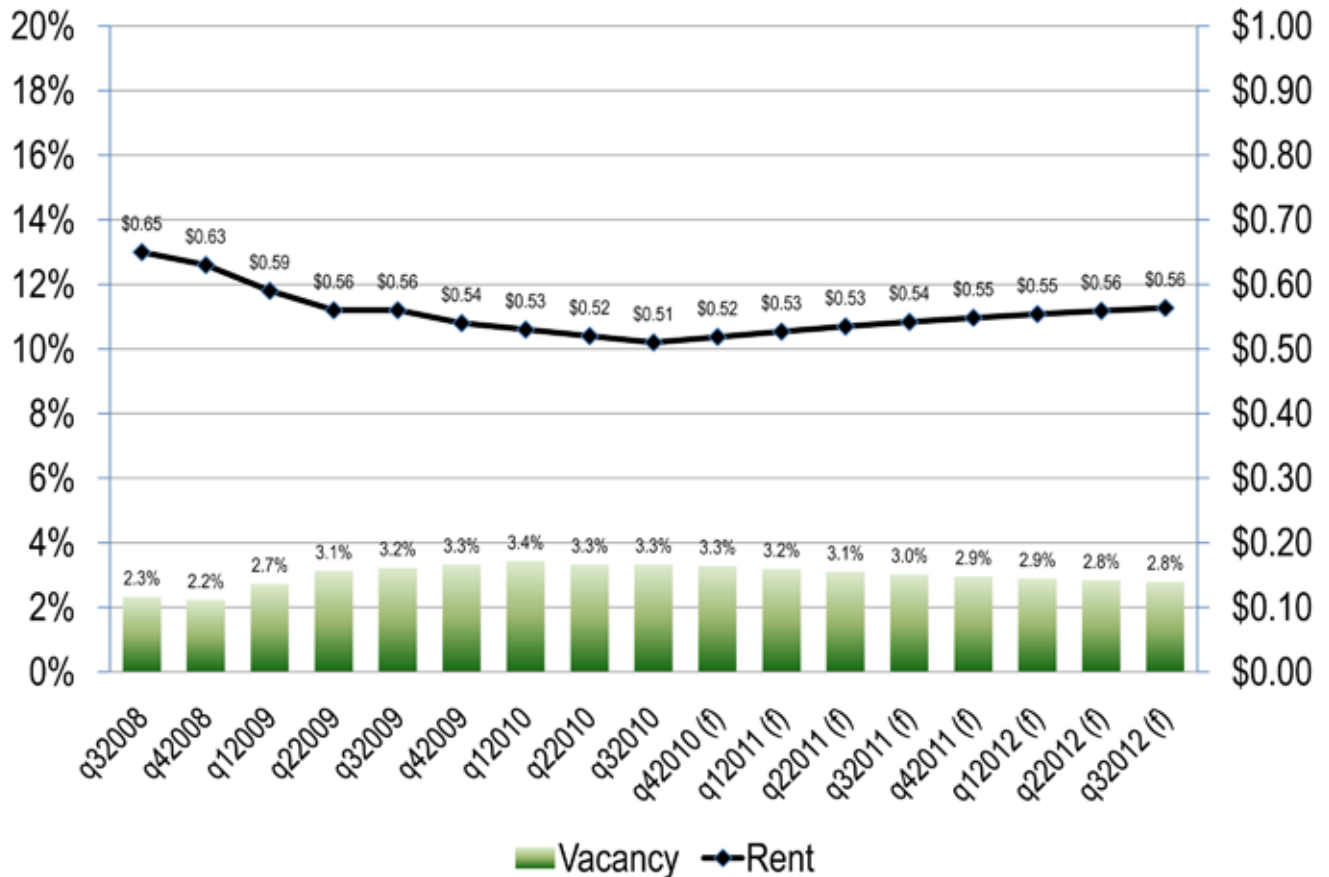
**Gasoline prices.** If the cost of trucking goods to and from the port area drops, firms engaged in importing and exporting may prefer warehousing and distribution space in the cheaper Inland Empire to the more expensive (but more accessible) Los Angeles County. Particularly high or volatile gasoline prices will favor the areas closest to the port in Los Angeles and Orange Counties.

**Speculative Development.** With land so plentiful and entitling so easy, the Inland Empire has long attracted developers with an "If you build it, they will come" mentality. Over-exuberance of developers could derail a recovery if too many projects begin construction before a sustained pattern of rent increases has been established.

In recent months, manufacturing output and container traffic at the Ports of Los Angeles and Long Beach have increased, helping to stabilize rents and boding well for future industrial demand across the Southern California region. We expect vacancy to decline and rents to increase in all metro markets over the next two years. Orange County is expected to post the largest percentage gains in rents and Los Angeles County the smallest. The Inland Empire region is expected to post the largest decrease in vacancy rate, both in absolute and relative terms.

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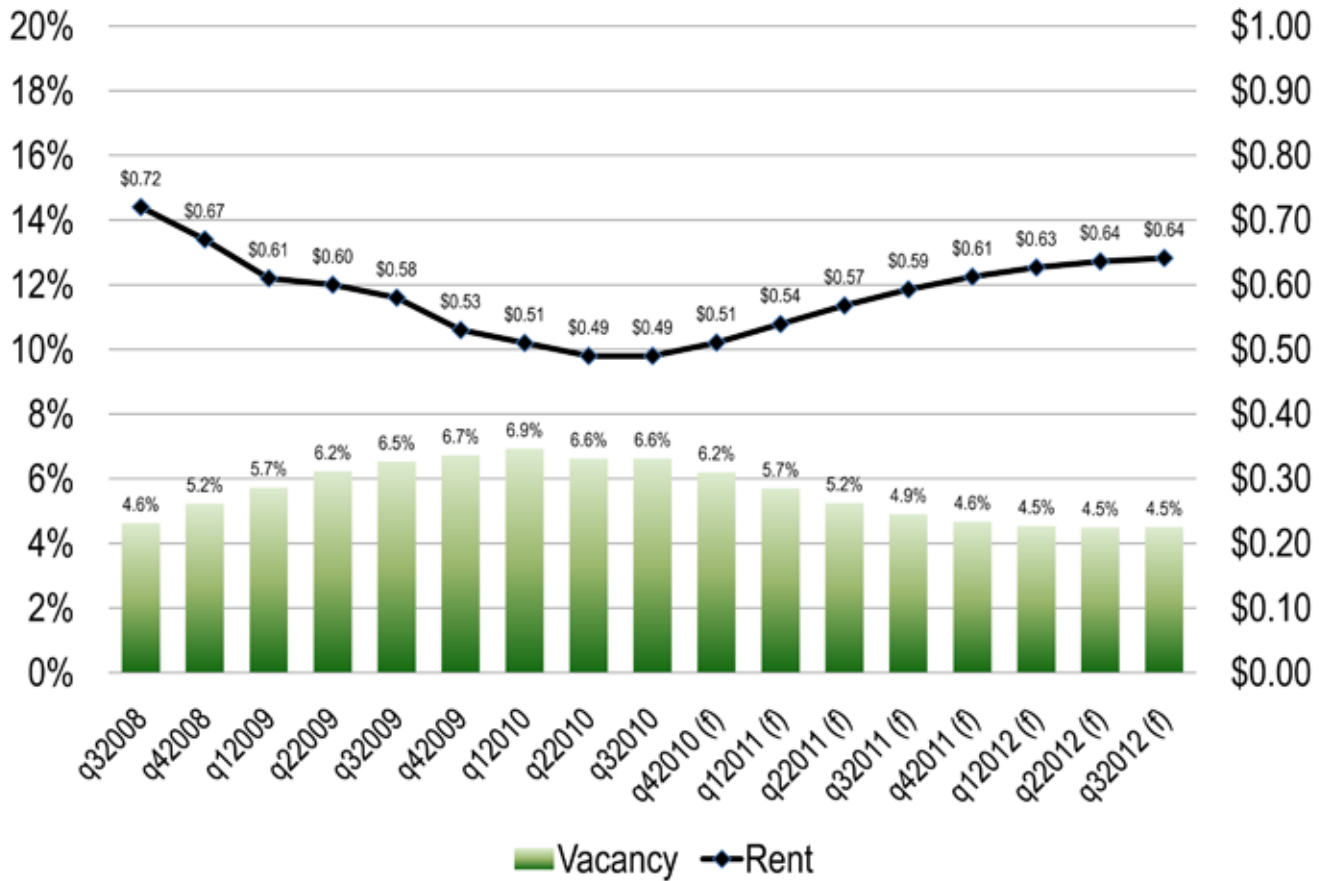
### Los Angeles Industrial Rent and Vacancy Forecast



#### LOS ANGELES COUNTY

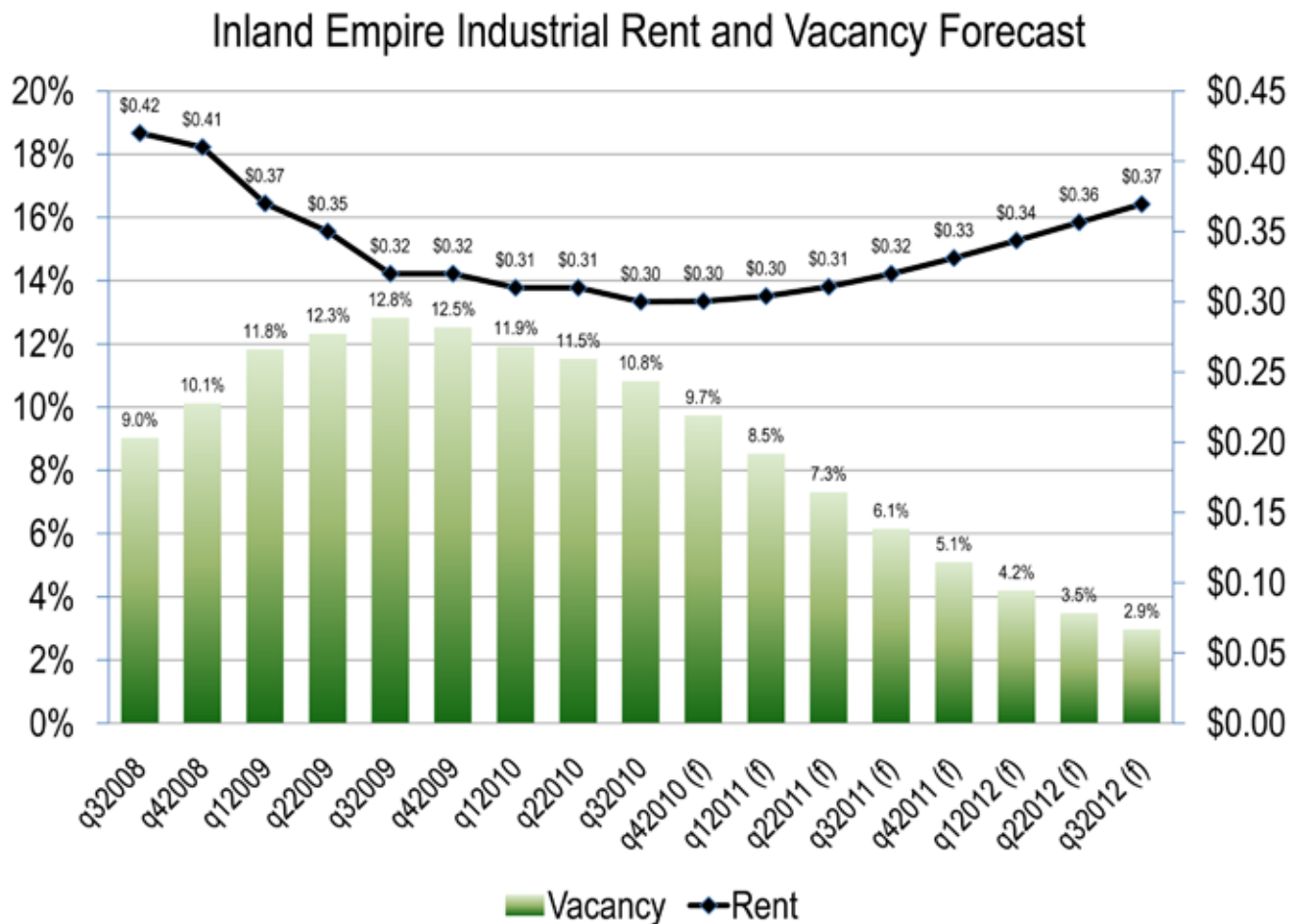
We expect rents to increase by 6.2 percent over the next four quarters and 10.5 percent total over the next two years to around \$0.56 per square foot. The vacancy rate is expected to decrease by one half percentage point over the next two years to reach a level of 2.8 percent. Because the market is so tight, small changes in rents will have an immediate impact on occupancy. Land scarcity near trade and transportation corridors and the relative difficulty in entitling new industrial buildings will help support a recovery in rents.

## Orange County Industrial Rent and Vacancy Forecast



### ORANGE COUNTY

Our model predicts rents to increase by 21 percent during the next year and 31 percent total over the next two years to reach \$0.64 per square foot. Although this result may appear extreme, rents fell 32 percent between Q3 2008 and Q3 2010. The rent level predicted for Q3 2012 would be slightly above the asking rents observed in Q1 2009. The vacancy rate is expected to fall 2.1 percentage points over the next two years to 4.5 percent.



## INLAND EMPIRE

We forecast Inland Empire rents to rise 6.6 percent over the next four quarters and 23 percent total over the next two years to reach \$0.37 per square foot. Our model predicts the vacancy rate to decline 7.9 percentage points to 2.9 percent. This level of vacancy has not been seen in the area since 2006 and will likely be tempered by the addition of new space should rents begin to head upward in the next quarter or two. Because the Inland Empire has historically been more volatile than other Southern California markets in terms of supply, vacancy and rents in the Inland Empire are harder to predict.

# USC LUSK CENTER **CASDEN** REAL ESTATE ECONOMICS FORECAST

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