

# The Gold Report

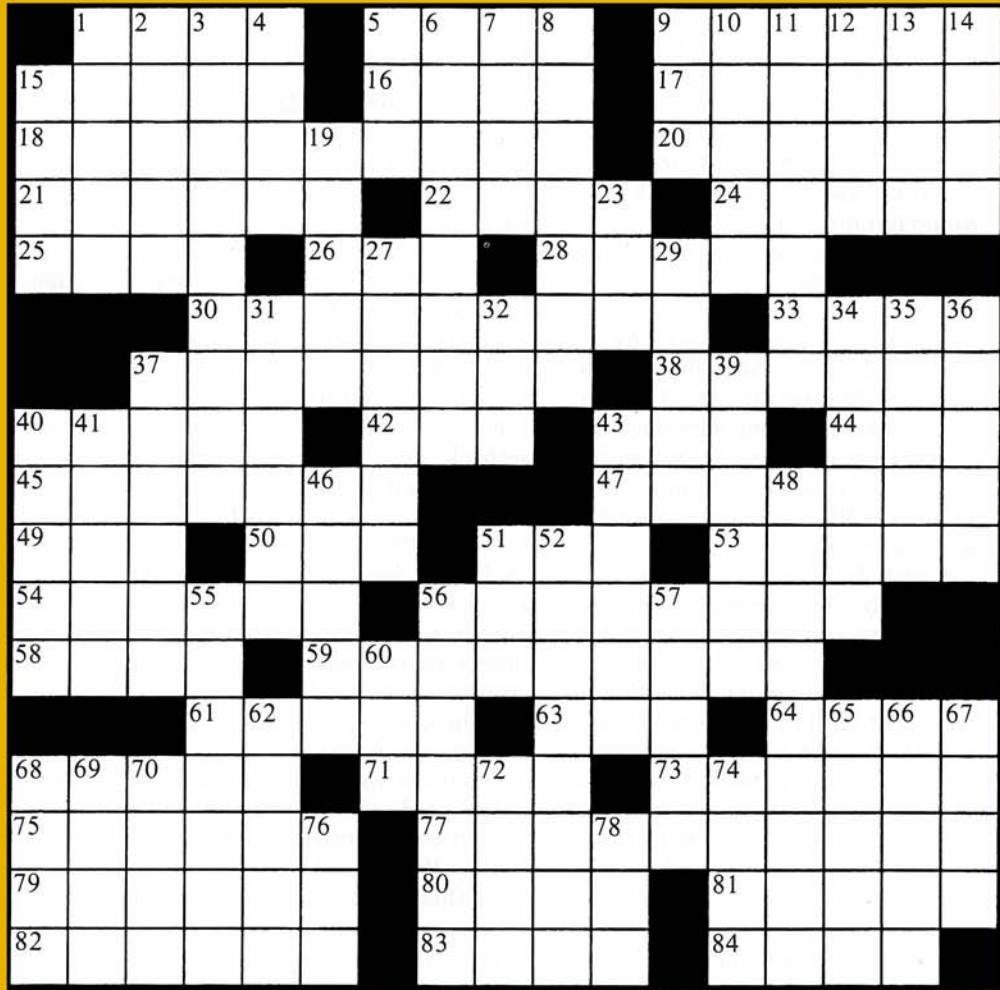
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... Questions? ... Answers?

## Commercial Real Estate 2012



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## Introduction

Welcome to the 2012 Gold report. We are all seeking answers (even the questions if you notice the cover!) But the way things are today, it's tough to have a clue to what's going to happen next. Which is why more and more owners, tenants and buyers are turning to us for help? For over 25 years we've been helping individuals and businesses fill in the blanks. No one has all the answers. But we can help you ask the right questions and solve the puzzle. Call and ask us. It's the best first question you could ever ask.

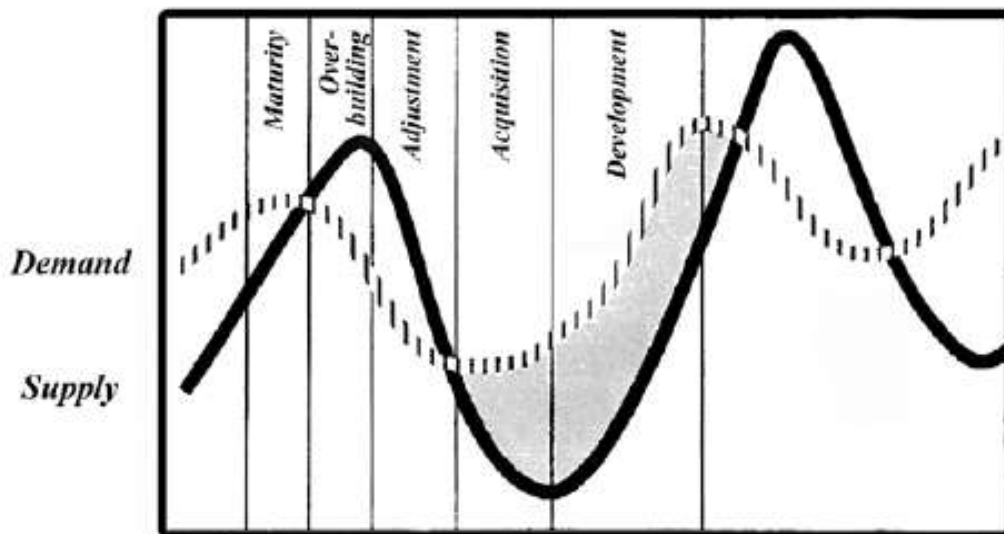
We got our hopes up the first half of last year as the market started looking better. But around midyear everything came to a halt. Domestic uncertainty coupled with global economic malaise sent individuals and businesses into a state of skittishness (at best) or paralysis (at worst.) In the current economic climate it can be easy to despair, but there is reason to be optimistic. Let's start with some truths that we still find to be self-evident. America remains an extraordinary place. While Washington may have descended into political tribalism, the nation has a bounty of people who are inventive, resilient, kind, hard-working, practical, self-reliant, tolerant and ambitious. They create some of the coolest stuff from the smallest smart phones and iPads to the biggest of things like the new 787 Dream Liner. America also produces a steady stream of inspirational stories from Tim Tebow to J. R. Martinez the Iraq war veteran with burns over 40% of his body winning *Dancing with the Stars*. 2011 had its fair share of good news. Most notably, US Navy Seals killing Osama bin Laden. Not garnering as many headlines but uplifting nonetheless;

- War casualties are the lowest in over 100 years despite the Iraq and Afghanistan headlines, casualties are lower than the 90's, 50's or 40's.
- The troops are coming home (and a lot to San Diego!) It doesn't matter where you stand politically, they're home and out of harms way, admirably and with honor.
- The economy is perking up 1.4 million jobs! Only 6.6 million to go!
- We're importing less oil - and most of it is from our friends in Mexico and Canada.
- Traffic fatalities are falling - lowest level ever recorded.
- Crime is dropping - defying hard economic times the trend continues from the 1990s.

Will Rogers once said, "Everything is changing. People are taking their comedians seriously and their politicians as a joke." This year will of course, bring challenges, scandals and setbacks. But it will also bring more good news, large and small. In 2012, people we don't even know yet will do amazing things (maybe one of your tenants or your broker!) Science will advance; enterprise will flourish.

In the past many reports have been written about the impressive economic engine which drives this region. Despite these trying times, their conclusions are still valid - this area has one of the strongest economies in the world. If that be true, then perhaps looking at San Diego's real estate market in terms of market phases will provide some clues as to what is in the future. The chart on the next page is the best explanation of real estate cycles we have found. These cycles will operate regardless of the problems which confront the industry today.

## Real Estate Market Phases



Shaded area indicates area of opportunity.

Market Phase	Symptoms	Appropriate Strategy
1. <i>Maturity</i> : Demand peaks but building remains strong.	Land prices have been bid up rapidly; new building has been active for 2 to 3 years; absorption is good but occupancy has weakened, and rents have begun to flatten.	Sell or plan long-term hold (3 to 5 years).
2. <i>Overbuilding</i> : Demand begins to decline as building reaches a peak.	The rate of absorption begins to slow; occupancy and rents weaken further; lenders and developers recognize the need to cut back starts.	Maximize liquidity; minimize speculative inventory.
3. <i>Adjustment</i> : Demand continues to drop, and new building starts turn down.	Severity of overbuild is recognized; starts plummet; occupancy and rents slide further; pessimism widespread.	Same as Phase 2.
4. <i>Acquisition</i> : Starts still decline, yet demand begins to firm, cutting into excess supply.	Pessimism/skepticism remains, so starts are cut back further; occupancy and rents have bottomed, and absorption begins to reduce existing inventory.	Buy existing properties; begin planning development projects with long lead times.
5. <i>Development</i> : Demand accelerates and building responds.	Occupancy is healthy again and rents are rising; strong absorption requires new development to meet needs.	Develop new properties or buy existing properties.

Source: MPIF Market Research, Dallas, TX

However, if you subscribe to the Mayan theory that the world ends December 21st of this year, never fear we have the answers for this life and death situation as well. You see I want you to take this year's Gold report with you, find an area where you can stand on your head and read it comfortably, because 2012 is going to turn your world upside down: but the Gold report is going to make it right side up. But if we find that the coming 2012 sends us to the afterlife sooner than we hoped, well then, at least you died happy and fulfilled because you read this report and our editorial at the end of it.

Thanks for the opportunity to do business with you and build our relationship together.

Regards,

*Don*

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## The U.S. Outlook

***“Likely to improve”, “anemic growth”, “so slow it will barely feel like upward movement”, “recovery will be a grind”, “growth lower than needed but better than expected”, “a slow and uneven path to recovery.”*** These are all headlines from trade papers describing the year ahead. And you wonder why they call economics the “dismal science!”

2011 saw the first time since 2005 that the US has generated positive hiring every month of the year. The unemployment rate fell in December to 8.5%. If you're going to pay attention to one thing it is the job market and unemployment. Job growth will add disposable income and allow consumers to unleash some pent-up demand. The small business optimism index has been rising since September. Increased small business start up and expansion and hiring confidence among small businesses is going to be a big plus for 2012. Commercial space is being leased or bought at a rate faster than new supply is being completed, reducing vacancies. Construction activity remains at record lows due to tight underwriting conditions and contracted demand. The small improvement in employment is resulting in a better-than-expected uptick in leasing and sales. It is our anticipation that this job market momentum will continue in 2012 contributing to a recovery in commercial real estate, occupancy, rents and values.

It is been my observation that in the end, he who has construction jobs wins. At this point in economic history, 70% of the Chinese economy is construction. By historical standards this would be to many and indicate a likely bubble. The U.S. On the other hand, doesn't have enough construction jobs which is a continued problem. As you see this problem fixed (eased lending, construction permit growth, job growth, innovations growth & venture capital deployment), commercial values will increase dramatically because of the lack of inventory and lack of new inventory in the pipeline caused by the great recession.

In the meantime, as we struggle to identify new employment engines, we expect the Federal Reserve to remain neutral all year, avoiding any action to stay out of influencing the election year one way or another. Commercial markets and prices will continue to recover. The national composite index of commercial real estate (CoStar) showed the first year over year improvement since the great recession started in 2008.

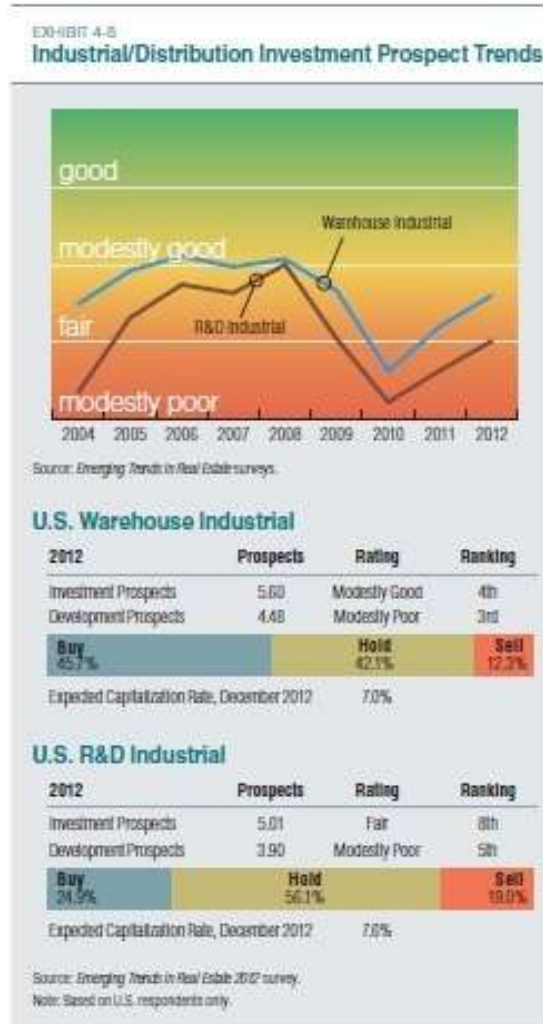
Looking forward, we think that the US economic fundamentals are improving although we are still vulnerable. America is a creative resilient country and has many assets and advantages that are still the envy of the world. In short, the economy will present many challenges in the year ahead. Our job will be to deal with the challenges and take advantage of the opportunities.





## Industrial Market

San Diego	Avg. asking sale price	Avg. asking rent	
Industrial	\$130.18 psf (-8.1% y-o-y)	\$.82 psf	(-2.3% y-o-y)
Avg. Purchase Cap Rate (Loopnet)	8%		



High unemployment, sluggish retail in the near moribund construction industry contributed to declining asking rates for lease (-2.3%) and for sale (-8.1%). This is a record three-year low. However, the lack of new inventory (none under construction) and a drop in vacancy from 11% back down to 10% gives us a sign of stability in the future increase in investment activity. When the construction industry returns expect a spike in rents as all of the contractors and their subs scramble for additional space. This should bode well for San Diego's supply constrained market. Owners of well located, old, functionally obsolescent buildings should start exploring the costs of maintaining their footprint but raising the roof and ceiling height ('15 to '38) to achieve higher rents to provide future new efficient tenants with more volume but not more square footage.



*world. They also need to be supported physically, and cognitively, and to feel a sense of belonging and connection to the organization's culture,"* says Jim Keane, president of Steelcase.

Today, the three factors that are important for the design of office space are creative environments, densification and collaboration. Spaces are more open to allow for the ability to scale to densities of up to 10 people per thousand square feet. Although the tenant may start out at four people per thousand square feet, the ability to scale within the space will enable the firm to expand without taking on additional space and without moving. To allow this densification, the space should have good light, open areas and a lot of power and outlets. Higher ceilings help reduce the feeling of being cramped into a tight area. However, be wary of parking problems. Most buildings are parked for only 3 or 4 workers per thousand square feet of space.

As stated earlier, job growth is the driving factor in San Diego's office market recovery. Moody's analytics employment forecast for the San Diego-Carlsbad-San Marcos MSA released in late August projects employment growing in all office occupying sectors except government this year. Tenants are also beginning to sign longer-term leases and moving less often which is creating value for owners. With a 16.25% market wide (suburban office) vacancy rate it will take 2 to 3 years before our office market can be considered stable, but it is working its way there.

**Retail Market**

Retail Buildings  
(Neighborhood center):  
Avg. Sold Cap Rate

Avg. asking sale price  
\$244.75 psf (-5% y-o-y)  
7.0%

Avg. asking rent  
\$1.78 psf (-2.5% y-o-y)

(Loopnet)

EXHIBIT 4-18  
**Retail Investment Prospect Trends**



The retail sector though seemingly slow, has recovered more than most people think. Nationwide retail vacancy averages are 11%. However; San Diego is sporting a near “boom time” vacancy factor of 6.36% that would make you think there would be more smiles. Existing tenant stress (not paying

rent) contributes to a “near vacancy factor” of almost double that. Though the worst is behind us, we need a sounder economy and consumer to rescue existing weak tenants or induce new tenants to the market. The good news is that the overbuilding we saw in the 1990s didn't happen this time around in retail, so the gains in occupancy will quickly lead to gains in lease rates and values. There is also still a fair amount of functional obsolescent space (unanchored strip centers, auto dealerships, and downtown storefront retail) which will take a much stronger economy to secure its redevelopment (versus just re-renting it in its present condition).

Retail nationwide still struggles with the bricks versus clicks conundrum. Is Best Buy a show room for Amazon.com? US spending online is up 14% year-over-year however, brick and mortar stores are experiencing sales growth as well. Shopping centers and stores offering free shipping or online items available for store pick up are all part of the transformation. Self checkout and e- wallets on your phone (AAA card, Starbucks card and library card are all on my phone now.). Some clothing stores are now experimenting with “virtual dressing rooms. “ You can see how the outfit will look on you and you can share on Facebook, Twitter or e-mail (so much for the girls trip to the mall.) Retailers are learning that they must give an in-store experience (Think Rain Forrest Café and ESPN Zone). Tenants offering more than hard products will be big winners. Tavern bowl is one such tenant in San Diego, offering social, food and drink and games and entertainment. They are neither a bar nor a bowling alley. The current growth in San Diego retail will revolve around the four “F's” - food, film, fitness and finance. Throw in a little medical (Dental, Doctor and alternative medicines) and you have the vast majority of the retail growth seen in 2011 and expected in 2012.

## **Investment Outlook**

Uncertain about the future of commercial real estate? It's no wonder. Bipolar reports from talking heads on TV and pundits in the press proclaim a recovery one month, and in the next the feared double-dip-recession.

What's it worth? This is the key question out there on the lips of clients, investors, appraisers, owners, bankers, lawyers, receivers, and brokers. Since the market nosedive in 2008 the market has crashed and remained essentially on the ground. Repairs have slowly been made but the fuel (financing) is still rationed.

Though sufficient financing is still the biggest problem, there are other major issues that still need to be addressed; regulatory reform (Dodd-Frank), tax reform, deficit reduction all affect the economy in general but commercial real estate specifically. Carried interest is a perpetual boogie man. Carried interest is a share of profits and partnerships paid to the manager of the partnership. Currently, earned interest is taxed at 15%, like capital gains which is fitting since most real estate is held long-term. Many would like to see this rate raised because hedge fund managers and private equity investors (even Presidential candidates) use carried interest rules to pay lower taxes on quick stock profits. However, what is lost in the debate is that more than 40% of all investment partnerships are for real estate. A change here could zap investors trying to bring life back to this depressed market.

Although we certainly didn't experience "Heaven in 2011". We do believe the recovery in commercial real estate is expected to continue in 2012. A sure sign are the "inside traders" like Sam Zell starting to wade back into the markets with billion-dollar purchases. We think that prices have bottomed and unemployment rates have started the slow trend downward. Lending also is slowly returning. Multifamily/apartment investments are on a tear as is typical with the first leg of any recovery. Low vacancy rates in retail bode well and industrial will rebound as job growth in construction returns. The lack of overbuilding in San Diego will lead to an eventual upward squeeze on rents and spike in values. You'll want to be sure you're in the market by then (we think you have the next two and a half years to get there.)

So you can better understand this real estate cycle you should study the Real Estate Market Cycle charts (on the next page) provided by the London Group Realty Advisors or my cycle chart in the introduction of this report.

Whether we own a skyscraper on Wall Street or a duplex on Main Street, the basic principle of income property remains essentially unchanged. We expect to collect money, mainly in the form of rent, and we expect to spend money to pay for the operating expenses and the loans against the property. When we're done for the year, we hope to have a surplus and to keep the tax collector from getting too large a chunk of it. Perhaps someday our prudent management and careful upkeep will combine with a healthy real estate market to allow us to sell the property at a profit and wise tax advice will keep some of that profit in our bank account.

To achieve these goals we at CDC Commercial need to help you take a careful and critical look at the income and expense data of any property you contemplate purchasing. Later, when you are ready to sell, our own figures can be examined with the same critical eye to provide a fairly realistic picture of the price your property may then command.

While there's been a lot of talk in the media about what's happening in real estate these days, this much is certain... commercial real estate has proven to be one of the greatest creators of wealth in

history. While it's true that the markets will change and that there will be times when appreciation happens faster than at other times, buying commercial real estate based on sound fundamentals in any market has paid off handsomely for seasoned investors in the long run.

***It's '12 but do you know what time it is?***



The London Group

## The CDC Editorial

Thank you for reading the 16<sup>th</sup> edition of **The Gold Report**. I hope you enjoyed reading it as much as I did writing it for you. (I am often asked if I write this myself... the answer is yes!) John Donne wrote a poem in 1624 that made the term, “no man is an island” famous (which talked to how interconnected we all are.) That poem ends by explaining that each man's death affects each of us and finally, asking “for whom the bell tolls, it tolls for thee.” Well, certainly these last four years have taken their toll on each and all of us.

*Boom! Big initial wave of job losses associated with retail closings.*  
*Boom! Discretionary spending is sucked out of the community.*  
*Boom! Lost sales tax revenues clobber essential local government services.*  
*Boom! Commercial tenants aren't getting enough revenue to pay rent.*  
*Boom! Commercial owners walk away from upside down properties.*  
*Boom! Second wave of job losses associated with commercial property market decline.*  
*Boom! Short-term commercial property loans reset causing more owner distress.*  
*Boom! Banks need bailout money.*

Despite the “toll” this economy has taken on all of us, commercial real estate markets have made progress. However, unemployment, debt levels, Dodd Frank and healthcare reform will cloud the picture for recovery. Sometimes it seems that the darkness of an economic slowdown will never end until it swallows your business like a pelican gulping down a fish. Well relax, that's not the way it is. Good times follow tough times - it's inevitable. They call it the economic cycle, and it's been around since people started measuring such things. It's just as important for a business owner to plan for the coming boom, as it was for them to prepare for the recession. But when do you start? How does one know it's really over?

There are no clear, defining lines from recession to boom. It isn't like throwing on a light switch in the room. It's more of a slow, gradual dawn lighting up the eastern sky, taking its time to arrive. We want to find trends, not sudden eruptions from good to bad - we want to go from bad to just a little less bad.

It's different this time: Sure it is, and the checks in the mail and you're my one and only. Don't believe what you hear from the economic pundits. Economics was invented to make astrology look good. In the late 50s and early 60s we had an economic boom partly based on new technologies like transistors. The “nifty fifty” stocks reigned supreme and surely it was different this time. Then along came the early 70s and Arab oil embargo. We were going to run out of oil in eight years, they said...it was different this time. Then we have the inflation and high interest rates of the late 80s, stock market crash of 1987, the 90s Internet boom, technology meltdown of 2000 followed by 9/11 and now the subprime crisis. Every downturn was followed by an economic boom and vice versa. It's never “different this time” and this is no exception. So let's start planning for the inevitable resurgence of economic growth.

At this moment it appears as though the economy is gaining a little momentum. The automobile industry is in slight rebound. Interest rates are so low that home buyers might actually top refiners. And corporate America is finally letting up a little on their purse strings. Rates are going to go up. The faster things improve; the sooner we'll see higher rates. The first part of higher rates is good. Going back to a normal yield curve is great - so long as it is a company by growth and not high inflation.

BEWARE: banks are still reluctant to lend to people, the stock market is still up and down, and world uncertainty has become more uncertain.

Within the framework of this opportunity, there's one thing you cannot do: WAIT.

The days of waiting to see what will happen, waiting to see when things will return to “normal,” and waiting for a sure sign of recovery are over. You cannot afford to wait any longer. You cannot afford to “get by” until the economy is once again safe. So there you have it. Take advantage of the coming expansion and remember, when things are looking super good and it seems like this boom will never end... That will be the time to prepare for the next recession!

I recently listened to a podcast by Umair Haque, an economist and author of Betterness – Economics for Humans. In it, he talks about the importance of a meaningful good life. The importance of measuring Gross Domestic Happiness not just Gross Domestic Product. Furthermore, he redefines “Goods – the stuff on the shelves of the big-box store.” to “Goods – the stuff that makes life; relationships, great accomplishments, passion, meaning and fulfillment.” Finally he encourages us to look beyond business where we get busier and busier and instead focus on Betterness, where we get better and better.

I also recently read a news story about a man who, although late for an appointment, stopped to help a stranger on the side of the highway change a tire. Nice, right? Just hold on... The tire being secure, the man gets into his car and drives off, but a couple of miles up the road suffers a heart attack! Meanwhile, the man he had just helped with the tire came along, called for help and performed CPR until medics arrived – saving his life. If the first man had not stopped to help with that tire, the second would not have been able to get there in time to rescue him.

The message here is not original, but is a very simple and profound truth. Sooner or later, you will get what you give, often multifold. Not just the normal things you do for people in your everyday life. It's the special times, the times when you see an opportunity to do something meaningful for another even though it is not convenient or enjoyable for you.

I've become a little famous for my stories at the end of my monthly client letter. I hope you appreciate the story that follows and that you can incorporate it into your retirement business planning or “betterness” planning.

As you finish this year's Gold report and take time to reflect on the past year (or the last year if you believe Mayan theories), your success, and your happiness, please also think about the homeless. They're not really homeless – because our community is their home – they are, in fact, “unsheltered.” I belong to the board of Interfaith Community Services (so I might be biased) but I can't think of a few “better” things than reinvesting in the community in which you invest.

We again wish to thank you for the opportunity to build our relationship with you, whether it has been the last 27 minutes as you read this report or the last 27 years as one of our first clients.

***Don Zech ~ Matt Orth ~ Candy Zech ~ Nancy Murphy ~ Anne Marie Malfi ~ Nick Zech***

**Team CDC Commercial**



## ***The Fisherman and the American Business Man***

The American businessman was at the pier of the small coastal Mexican village when a small boat with just one fisherman docked. Inside the small boat were several large yellowtail tuna. The American complimented the Mexican on the quality of his fish and asked how long it took to catch them. The Mexican replied only a little while.

The American then asked why didn't he stay out longer and catch more fish? The Mexican said he had enough to support his family's immediate needs. The American then asked, but what do you do with the rest of your time? The Mexican fisherman said, "I sleep late, fish a little, play with my children, take a siesta with my wife, Maria, stroll into the village each evening where I sip wine and play guitar with my amigos, I have a full and busy life, Señor.

The American scoffed, "I am a Harvard MBA and could help you. You should spend more time fishing and with the proceeds by a bigger boat, with the proceeds from the bigger boat you could buy several boats, eventually you would have a fleet of fishing boats. Instead of selling your catch to a middleman you would sell directly to the processor, eventually opening your own cannery. You would control the product, processing and distribution. You would need to leave this small coastal fishing village and move to Mexico City, then LA and eventually NYC where you will run your expanding enterprise."

The Mexican fisherman asked, "but Señor, how long will this all take?" To which the American replied, "15 to 20 years." "But what then, Señor?" The American left and said, "That's the best part. When the time is right you would announce an IPO and sell your company stock to the public and become very rich, you would make millions."

Millions, Señor? Then what? The American said, "Then you will retire. Moved to a small coastal fishing village where you would sleep late, fish a little, play with your kids, take a siesta with your wife, stroll into the village in the evenings where you could sip wine and play your guitar with your amigos."



**Most People Think the Homeless in America are:**

- ~~Old~~                    The truth is: the average age of a homeless person in America today is NINE years old! Every night in North County there are over 1,000 homeless children.
- ~~Male~~                    49% of Interfaith’s homeless clients are women.
- ~~Single~~                    Close to 40% of the homeless are families.
- ~~Unemployed~~            A survey of 30 U.S. cities found that almost one in five homeless persons is employed.

(U.S. Conference of Mayors)

**It could happen to anyone!**

For over 25 years Interfaith has been helping people find shelter, food, clothing, and much more!

**We need your help NOW!**

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I/We wish to donate \_\_\_\_\_ \$25 \_\_\_\_\_ \$50 \_\_\_\_\_ \$100 Other \$ \_\_\_\_\_

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**“Re-invest in the community in which you invest.”**

**CDC Commercial** will make a \$25 donation for every donation we receive through The Gold Report. Please make your contribution to Interfaith Community Services and send it to CDC Commercial. We will add \$25 and deliver it.