RED CAPITAL RESEARCH

California Regional Report

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FOURTH QUARTER 2007

EXECUTIVE SUMMARY

National Economic Trends

- The pace of economic expansion was considerably weaker in the fourth quarter 2007. Real gross domestic product advanced at a 0.6% seasonally-adjusted annual rate, significantly below trend and comprehensively slower than the 4.9% surge recorded in the third quarter. The housing downturn was largely to blame: residential fixed investment fell 25.2%, as developers cut production in order to stem a sharp rise in unsold home inventories. Personal consumption advanced at a 1.9% rate, down from 2.8% in 3Q07, and import levels fell 1.9% on sluggish domestic demand. The decline in spending was felt most acutely at retailers exposed to the housing industry, especially building supply, home furnishings and department stores, which registered declining sales year-over-year. Even export growth, which ignited the economy in the third quarter, decelerated significantly, dropping from a 19.1% burst in 3Q07 to a more modest 4.8% advance.

- January and February payroll data suggest that the economy continued to decelerate in 2008 and raised the prospect that GDP growth will be negative in the first quarter. Establishments trimmed 22,000 and 63,000 jobs, respectively, in January and February, the first seasonally adjusted losses recorded since August 2003. On a year-over-year basis, payroll employment rose 0.6% in February, the slowest annual comparison observed in 48 months. New orders for manufactured goods fell 2.5% in January, following a 2.0% increase in December. This decline was primarily attributable to reduced demand for cars, trucks and other transportation equipment, which fell 13.0% following a 10.1% gain posted in December.

- National City Bank economist Dr. Richard DeKaser forecasts GDP growth to decelerate to 2.1% in 2008 but rebound to 2.6% in 2009. Similarly, the rate of payroll growth is expected to fall to 0.5% this year, and accelerate to 1.1% in 2009.

California Economic Trends

- The pace of state year-over-year employment growth fell to a meager 30,700 (0.2%) in 4Q07 and 21,000 (0.1%) in February. The sluggish trends were largely attributable to housing market woes. Construction firms, building supply retailers, wood product producers, lumber wholesalers, banks and real estate agencies lost a combined 120,800 employees year-over-year in February.

- The most recent re-benchmarking exercise at the BLS was unkind to California. The initially estimated count of 15,414,600 jobs in December was downwardly revised to 15,290,500. The Inland Empire was the hardest hit. The BLS initially estimated that 42,300 (3.3%) jobs were created in 2007 but revised figures pegged the number at 1,100 (0.1%). Similarly, the 5,200 (0.3%) job gain in Orange County was revised to a -6,000 (-0.4%) job loss and about 10,000 jobs were taken away from the Oakland tally.

- In light of the revised data, **RED** predict a minor contraction in the Golden State this year. Our econometric model generates a point estimate of -30,000 (-0.2%) jobs. Domestic economic trends should improve next year, giving rise to a 107,000 (0.7%) increase in state payrolls.

Total Return Analysis

- Three California metros demonstrate above average risk-adjusted returns; San Diego (3.09 RAI), Sacramento (3.03 RAI) and Orange County (2.83 RAI). The Inland Empire falls just short of this threshold but the Bay Area metros and Los Angeles are far below average. The former suffer from extraordinary historic NOI trend volatility. Los Angeles, on the other hand, is less volatile but does not offer an attractive total return profile due to Reis skepticism regarding rent and occupancy trends.

Investment Rankings

- Only San Diego and Sacramento earned ***Accumulate*** rankings based on our updated analysis. Both markets offer above average rates of expected return and risk-adjusted returns alike. We are far less optimistic with regard to the other California metros. Low yield markets such as San Francisco, Los Angeles and Oakland are priced to perfection and exhibit excessively high NOI growth volatility. In these markets, **RED** advise investors to proceed with caution and holders to consider ***monetizing unrealized gains*** before economic conditions force cap rates higher. In San Jose, prices are supported by current fundamentals but the performance profile does not adequately compensate investors for inherent risks. We assign an ***Opportunistic*** ranking; purchase assets at a discount. Due to high asset prices and economic uncertainty, investors are advised to ***underweight*** acquisitions in Orange County and the Inland Empire.

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