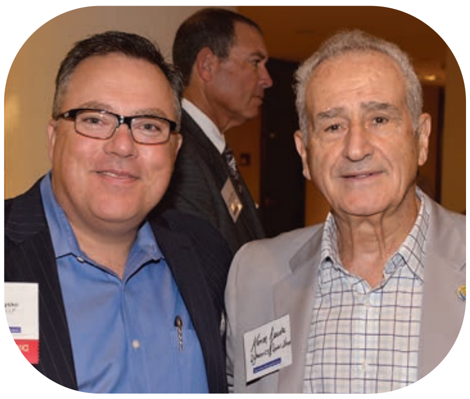
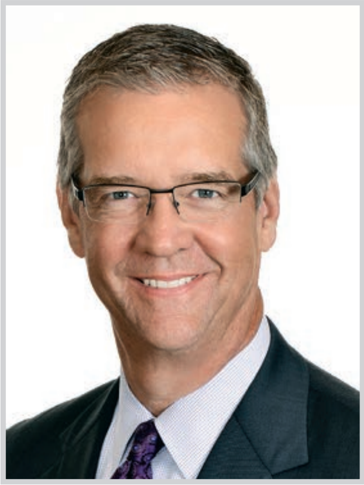
2014 MID-YEAR ECONOMIC FORECAST & TRENDS





PANELISTS



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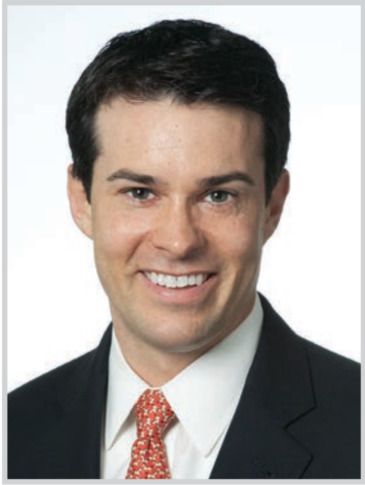

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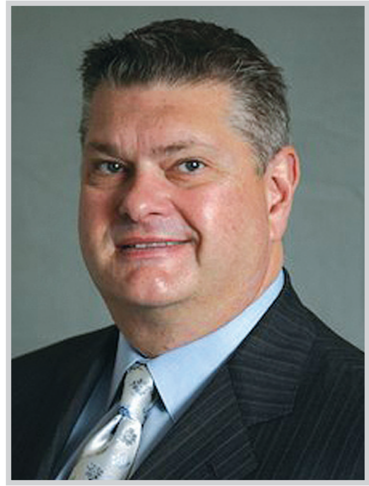

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On Thursday, July 31st, the Los Angeles Business Journal and San Fernando Valley Business Journal teamed to host a round-table style discussion on economic trends and forecasts for Los Angeles County and Southern California. Our panel of regional experts shared their insights on the biggest headlines of 2014 thus far and where they feel the market is going for the remainder of the year.

Moderated by the Los Angeles Business Journal's Publisher and CEO, Matt Toledo, the discussion was spirited, informative and insightful.

To help get the conversation going, we asked several of our expert panelists to answer a few general questions about our current economical state of affairs in advance of the event. What follows is a run through of their spirited and informative responses to our questions.

2014 - A Look Back at the first half of the year

In terms of issues that impacted their businesses – from the workforce to healthcare to financing and taxation - what has worried your clients most?

Bollinger: Interest rates and taxes are always at the forefront of client concerns, but this past year those issues were trumped by compliance concerns. Dodd Frank and the resulting Consumer Financial Protection Bureau (CFPB) rules and regulations combined with the changes wrought by the Patient Protection and Affordable Care Act provided a constant stream of inquiries from clients. The healthcare issues alone contributed to the trebling of the size of our Healthcare Department over the course of the last year.

Fulp: My clients were kept up at night by the fear of being unable to successfully source opportunities and allocate capital into the Los Angeles market. We experienced $17.3 billion of commercial sales in L.A. over the past 12 months, which is respectable when compared to 2007 at $20.8 billion; yet, we haven't been able to completely satisfy investor appetite. If we don't see greater transaction volume, pricing will need to continually rise until demand is tempered or fundamentals no longer can support the seller's ask.

Rasco: Clients remain concerned over several issues. The economy, which went through a mini Ice Age in the first quarter, should rebound in the remainder of 2014. The hope is that is a sustainable rebound. Also, the rebound in European economic growth remains concerning as the central bank seems to need to do more to boost activity. Clients are not yet convinced that rebound is real or sustainable either. Geopolitical events around the world are also a concern.

Which industries had the biggest change in growth over the past 12-18 months, in terms of jobs, revenue or market share?

Wilson: Real estate has been one of the biggest drivers of job growth. Residential projects have restarted, after years of being dormant, as the housing market is on its way to recovery and properties are selling for increasing prices. Commercial construction is also on the uptick as investors and lenders are more confident.

Rasco: Cyclical industries suffered with the slowdown in activity in the first quarter. There has been a rebound in certain sectors. Job growth has been focused on low paying services sectors.

What industries are most likely to see growth over the next 12-18 months?

Wilson: Technology companies anchored in the Silicon Beach area of Santa Monica and Venice are creating jobs and injecting a boost into the economy. Along with start-up companies, household names like Google, Amazon and YouTube have significant operations in the Los Angeles area. With the rapid evolution of the start-ups, some of them will become the household names of the next year or two, through acquisitions or IPO's.

Rasco: We are looking for a solid outlook globally for energy, agriculture, manufacturing, technology, and industrials.

Is the year shaping up like you predicted?

Rasco: No, the rebound in economic growth has been more muted globally than we thought it would have been. China looks to

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BERNARD BOLLINGER

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be closest to its target of 7.5% as expected. The US will have to work hard to grow faster than it did last year. Europe's economic growth remains weak and the rebound has been less pervasive than we thought. It has been focused on Germany and England more than forecasted.

Fulp: Although we have experienced a recovery in L.A. that resembles more of a crawl than a bounce, we are picking up speed and gaining momentum as anticipated. Vacancies are trending down, rents are moving up, and we are now at an inflection where some of the more attractive submarkets are turning into a landlord's market. Looking ahead, I am concerned about how many functionally obsolete buildings there are and how very little product is under construction. New office, retail and industrial under construction amounts to less than 0.5% of the total existing square footage in each of their respective sectors. If L.A. begins to experience a moderate uptick in tenant demand, we'll have a serious supply issue on our hands and rents will inevitably be pushed much higher. We need to remember that technology now allows companies to scale more quickly, but greater regulation has made it more difficult and timely to entitle, permit and construct.

Wilson: We expected 2014 to be an improving year, but it seems much stronger than expected. Our clients are involved in more deals, increasing operations internationally, and increasing the amount of planning and consulting to understand the economics as well as tax implications. The public markets for our microcap public companies is stronger than it has been since 2008, which points to investor confidence as well as management's willingness to invest in the future.

Bollinger: As an insolvency attorney accustomed to the counter-cyclical nature of my practice, I expected a significant slowdown this year as the economy improved, so I haven't quite figured out why my entire department of nearly twenty insolvency-focused attorneys remains busy. I suspect it is indicative of an economic recovery that has buoyed certain industry niches (real estate development, for instance) but has left others foundering.

2014 & Beyond – General Economic Trends

What is your outlook on the health of the Los Angeles area economy for 2014 compared to the same time last year?

Wilson: As the unemployment rate continues to decrease, coupled with an increase in consumer confidence, we see 2014 continuing to gain strength and momentum through all areas of the local economy. There is an influx of foreign buyers for residential real estate, as they recognize that Southern California is undervalued and has a strengthening economy. Tourism increases as consumers feel they can spend disposable income, which leads to jobs in the hospitality sector.

Bollinger: This time last year the view from my office window revealed a single skyscraper in the midst of construction. Now there are four. While this isn't necessary emblematic of the state of the Los Angeles area economy, it certainly lends credence to the notion that the outlook is rosy. Yet it remains to be seen whether the apparent real estate boom will translate into the type of broad-based recovery that the Federal Reserve has been working so hard to foster. One thing appears certain—things are better here than in many parts of the country and savvy local businesses are in a position to capitalize on that development.

What are the biggest challenges in doing business in Los Angeles compared to other markets?

Rasco: Los Angeles is a fragmented and decentralized market. The Bay Area has done a great job of developing its ecosystem, connecting companies to employees, resources and capital. When comparing the two regions, L.A. has the elements to rival the corporate desirability of the Bay Area but we need to do a better job of connecting people. One obvious step in the right direction is to continue to improve the region's transportation network and leverage all modes of transportation. We are now a multimodal society, so the solution is not just Metro Rail and carpool lanes. We need to keep innovating while also employing amenities such as Zipcars in parking garages of office buildings, city bikes that can be shared, and allowing Uber, Lyft, Yellow Cab and other shared or paid service providers to compete for our business.

Wilson: One of our biggest challenges is traffic and the lack of a public transportation infrastructure. Compared to other large metropolitan areas, there is no network that allows people to be transported in an efficient, cost effective manner. An added complexity is Los Angeles has several major business hubs, rather than a central downtown area. Technology allows increased and efficient communication, but there is still no substitute for the face-to-face meeting.

What industries are most likely to see growth?

Fulp: Technology and technology related companies. Los Angeles has more than 70,000 engineers (the most in the country), Southern California has 5 of the nation's top 20 engineering schools, and more engineers are enrolled at USC and UCLA than at Stanford and Berkeley. The cost of housing, office space and staffing is also now cheaper in L.A. than the Bay Area. The climate's tough to beat as well, especially as this time of year can feel like winter in San Francisco. Clearly, talent, lifestyle and cost are not the issue for L.A.; we need to further develop the region's start-up ecosystem and attract more venture capital so that we can accelerate growth.

Wilson: With the recent implementation of Obamacare, the healthcare industry will have far reaching effects. Everything from the way health care is delivered, to the billing and the effect on the federal government with IRS involvement in monitoring the enrollment and penalties, point to increased complexity and administration of the system. This affects employers, who are concerned about the number of full-time employees that receive benefits and limit the number of hours worked to minimize costs.

What are you hearing from small business owners regarding their opportunities in the Los Angeles area? How do we address the concerns of small business?

Bollinger: While small business owners have been impacted by a number of issues, the two most prevalent concerns are the ability to attract high caliber employees and to access capital. The employment issue is perplexing, as recent reports have demonstrated that the unemployment rate is going down yet the percentage of employers that cannot find the employee they need has gone up. While banks may be more willing to lend, regulatory pressures have resulted in access to capital for primarily the very most credit-worthy businesses and little increase in lending to small businesses that don't have the requisite asset base. Neither of these issues can be resolved immediately, but both may be incrementally favorably addressed as the economy improves.

What is the most pressing jobs issue?

Rasco: The most pressing jobs issue is the quality of jobs and the role of technology. Many of the jobs created this year have been low paying services jobs in the services industries. That is why this has been the slowest expansion in terms of wage growth in the post-World War II economy.

An "Industry Specific" Look

Regulations and taxation in California have become notoriously burdensome for businesses here. How great is the

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risk of business flight from Los Angeles and, more generally, California, due to over-regulation and taxation?

Fulp: In 2014 Los Angeles certainly experienced some high profile job loss announcements with the departure of Toyota and Occidental Petroleum to Texas. State leaders, however, have made it clear this legislative session that they are committed to keeping advanced manufacturing and technology companies in the state. The Governor recently signed legislation that would provide a 10-year tax break for commercial spacecraft manufacturers, such as Hawthorne-based SpaceX, and a $420 million tax credit for aerospace companies such as Lockheed Martin and Boeing. As we saw with Mayor Ed Lee in San Francisco with the Twitter tax break, local government can also help bolster further investment. Mayor Garcetti has already demonstrated significant leadership and willingness on this front and has the opportunity to make a big economic impact at just the right time.

Wilson: The cost of doing business in California is a real concern to business owners and companies. From the cost of workers’ compensation insurance to tax rates that are among the highest in the nation, employers, and specifically manufacturers, are looking to other jurisdictions with lower costs of doing business. At some point, the cost of wages, insurance, and taxes, out-weigh the benefits of having operations in California. Not all employers have the ability to move operations out of state, but losing companies and the jobs they provide hurts our economy and reduces our state’s tax base.

2013 was generally considered to have been a “flat” year for middle market mergers and acquisitions. What are the prospects for increased activity in middle market mergers and acquisitions in 2014?

Bollinger: There is no question that we have seen a marked uptick in mergers and acquisitions activity in 2014. While the increase in activity has been industry-wide, we’ve seen a lot of activity in the apparel industry, where private equity and foreign investment have both played a role in heating up that market segment.

Is access to capital generally more fluid and are banks more aggressive in corporate lending?

Rasco: Regional bank lending, according to the Fed’s Senior Loan Officer Survey, has picked up in recent months and lending standards have been loosened. C&I loans have picked

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up and lending for commercial banking has been rising in 2014. Another source of capital has been in the M&A arena, as corporate cash stockpiles remain quite high. Companies are acquiring the organic growth of the future as they are purchasing competitors around the world. Finally, from a global perspective, capital is now available from the world of the emerging market economies. We have never seen the BRIC economies of Brazil, Russia, India, and China set up the New Development Bank with $50 billion of capital and lending capability of multiple times that number. Moreover, the EM corporate sector remains focused on global growth and also has seen corporate cash levels rise consistently since the onset of recovery in this business cycle.

Fulp: When it comes to commercial real estate financing, banks are more aggressive but so are conduit, bridge, mezzanine and life insurance companies. The number of firms actively lending and the amount of capital at their disposal is significant. In fact, we are starting to see the various lending types converge on certain deals; in other words, a bank may not just be competing against another bank for a loan assignment, but also with conduit and bridge lenders. As an example of the market's strength, there are currently more than 40 active conduit lenders that have provided $126.7B of financing over the past 18 months. That amount is more than in all of 2008, 2009, 2010, 2011 and 2012 combined ($107.5 billion).

Bollinger: There is more access to capital for the most credit-worthy borrowers, and the increased competition for these borrowers has led banks to be less restrictive on loan terms to those borrowers. Nevertheless, there remains little appetite for risk, in large part due to regulatory issues and low interest rates. While some have commented that this attempt by regulators to make banking as boring as warehousing might lead to a loss of talent in the banking industry, it certainly has led to an inability of banks to creatively address the capital needs of a large number of small and midsized businesses.

Where are businesses finding success raising capital? What could be done to further those successes?

Fulp: While growth spawns from liquidity, rapid growth has most recently come from venture capital. The L.A. region clearly has the ingredients to fuel the creative and tech economy, but businesses could benefit from greater access to venture capital funding. In 2013, venture capital firms invested $12 billion in Silicon Valley businesses

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compared to only $1.7 billion in the Los Angeles/Orange County region. Last year's division of the VC pie is also consistent with historical averages. Los Angeles could do a better job of promoting our region to the VC community outside the region, while also working to develop a greater VC presence within the region.

We hear that businesses want to know the current state of the banking industry, but what they really want to know is … are they lending?

Wilson: Banks have increased lending… cautiously. They are looking for companies with a proven track record of earnings and the ability to collateralize the loans, often with personal guarantees. Lenders with an SBA group are seeing an increase in clients willing to expand, especially those borrowers with a mix of real estate and operations. This, combined with many companies who are not actively looking to finance their growth, results in less lending than the improving economy would indicate.

What changes are expected within the Real Estate Industry?

Bollinger: The two issues that are most likely to require change in the real estate industry are the shrinking demand for retail space and the need for municipalities to increase revenue. An increase in internet sales has boosted the need for warehouse space but has begun to gut shopping centers previously reliant upon big box retailers. The manner in which developers address this issue will have a direct impact upon the tax base of local municipalities. That issue has exacerbated the financial travails of many municipalities and may result in the loosening of development restrictions in order to increase revenue.

Fulp: A couple of the biggest changes are the democratization of real estate through technology and the repurposing of existing properties. Whether you are raising capital on a crowdfunding website, selling property on an auction website, or using online survey tools to retrieve location, design and amenity preferences from an entire workforce – the playing field is being levelled. We're also seeing a lot of buildings be converted to creative office space as we move to a more highly skilled workforce, and we are watching retailers move to smaller formats as commerce moves online while warehouses become automatized. The reality is real estate that is used by people is not just about the physical space any more. It needs to provide significant intangible benefits.