

San Diego Daily Transcript

Established 1886

THE BUSINESS DAILY

75¢ Per Copy

February 4, 2008

Panel: S.D. commercial office market should rebound in 2 years

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San Diego County's commercial office market is soft, but not so soft that it won't rebound within a couple of years.

That was the assessment at a **Commercial Real Estate Women (CREW) San Diego** meeting Thursday at the Sheraton Hotel on Holiday Court in La Jolla.

Bill Fleck, president of the Staubach Co.'s San Diego office, said Class A vacancy is running at about 18 percent and headed higher while rents have continued to climb if at a much slower pace.

"Why the disconnect? It's because replacement costs are so high. Construction costs have climbed and land is scarce," Fleck said.

Lynn LaChapelle, a Jones Lang LaSalle (NYSE: JLL) capital markets division managing director, said San Diego County had about a 16 percent office vacancy at the end of 2007 -- a vacancy she expects will climb to more than 20 percent by year-end.

The region had a 12.4 percent office vacancy at year-end 2006.

Today, Fleck notes that rent growth is now falling below projections, 2 million square feet of office space is under construction in the county, and unemployment is rising.

"We are seeing increased concessions, increased supply and deeply discounted sublease space," Fleck said.

"That's going to drag down the market in Southern California until 2010, but most of our customers are still doing well."

Fleck did say tenants will be expecting more generous tenant improvement allowances for at least the next couple of years, however.

Paul King, an Arden Realty/GE first vice president, said after peaking in mid-2007, the office market in the second half of the year had been as slow as he as ever seen.

King suggested the market has picked up somewhat with the coming of the new year, but that investors will need to be smart and prudent to survive.

"But I'm confident the market will turn around in 2009 to 2010," King said.

Charles Stos, Master Development Corp. development manager, who may be best known here for building the Three Piper Ranch, a warehouse distribution center project on Otay Mesa, said he has seen some properties around the county that have come full circle.

This means that land originally slated for industrial development was snatched up by generally publicly-held homebuilders who now find them too expensive to hold, and are selling them back to industrial developers.

"And it's not a great leasing market right now," Stos said.

Stos said while he doesn't believe the recession will start until 2009, potential purchase transactions must look very good if they are going to be touched.

"We're going to keep our powder dry. We won't jump on a deal unless it's phenomenal," Stos said.

"There are turbulent waters ahead," LaChapelle added.

While there were numerous major plays for some prized San Diego commercial real estate last year, LaChapelle said transactions will be much more difficult "because people haven't been able to price the debt."

LaChapelle, who said a recession is likely this year, said the housing market won't bottom out until late 2008 or early 2009, and the impacts will be carried into the commercial sector as well.

"Office demand will be nominal or negative in markets as layoffs by residential lenders, commercial and investment banks continue through year end," she added.

While much has been made about the reductions in the federal funds rates, LaChapelle said it will be a while before that has an impact on commercial markets.

"Interest rates really haven't changed that much," she said.

As the slowdown impacts landlords' ability to fill space, LaChapelle said many real estate investment trusts are taking a big hit.

Nationally, she said the REIT business is off by 36.6 percent from its all-time closing high in February 2007 and down 27.7 percent since October.

On the private side, The Irvine Co., which went on a billion dollar buying spree last year, paid a record \$700 per square foot for the Regents Square office property in the University Towne Centre area.

LaChapelle said given the slowdown, it could be a long time before such a price is paid again.

LaChapelle said while the "tech wreck" early in the decade created more than its share of problems, this one feels somewhat more worrisome because of capital (a dearth of investment banks in particular) and debt constraints.

Not all is negative, said LaChapelle, who also predicted an office market turnaround in about two years.

He said the demand for biotechnology space -- particularly on the Torrey Pines mesa -- is expected to increase this year.