

COMMENTARY

Gary London >> COMMENTARY

Commercial Tenants Are Enjoying 'Salad Days'



These are the dark days for commercial property. That is, if you own any of it.

The statistics tell the story: The current San Diego County office vacancy rate (including sublet space that is under contract but available) is 15.6 percent, according to CoStar.

Other sources place the percentage three points higher. Among the three most prominent Class A markets — downtown, UTC and Carmel Valley — the weakest market is UTC at 21.6 percent vacant.

Absorption activity has been backwards in San Diego, with negative net absorption of 1.5 million square feet over the past year, a decrease in occupancy of approximately 2.4 million square feet, according to CoStar.

The slowest sub-market is UTC with negative net absorption of 760,000 square feet, the best is downtown with negative net absorption of approximately 150,000 square feet.

Nationwide, the office space market had a net negative absorption rate of 25 million square feet in the first quarter of this year, with 20 million square feet of space recorded in the second quarter. This is the sixth quarter in a row where there has been net negative absorption.

This trend will continue with experts predicting an average rate of 11 million square feet towards the end of the year.

Realistically, there is no chance of a recovery or even signs of a recovery until 2010.

The good news is that there are few new office buildings under construction, so at least the pipeline will stop, allowing the market to eventually catch up to it.

This is all reflected in lease rates, which have been declining with the market.

According to CoStar, new lease rate quotes are \$2.42 per square foot per month for the county, down from the \$2.58 to \$2.67 per square foot range last year, but this varies by sub-market, with the Carmel Valley market performing at the highest levels, and the downtown market performing at the lowest levels.

Salad Days

However, if you are a tenant or represent them, these are the salad days.

Most tenants who know they are important to their landlords have entertained, initiated or culminated the process of renegotiating leases.

Most landlords have been accommodating, which is certainly reflected in these lease rate numbers.

David Marino of **Irving Hughes**, which specializes in tenant representation, offered up examples of "right sizing."

Four years ago a biotech company in Torrey Pines leased 90,000 square feet to accommodate its thriving business. The economy has forced them to lay off 50 employees and the company is only using 40,000 square feet. When their lease is up next summer they will "right size" to a 40,000-square-foot building.

A software services company in Sorrento Valley that has laid off workers currently has 45,000 square feet and will "right size" to 30,000 square feet when its lease expires in October.

Both companies will be able to get enough free rent to offset the cost of moving, and therefore they will have no incentive to stay where they are.

"Many sub-markets are going to see

significant negative absorption over the next two years," said Marino. "But it won't happen overnight. It will happen lease by lease. Every week as leases expire, landlords will be scratching their heads, wondering what happened."

What's driving the market down? It's the current economic downturn, as unemployment is now at 9.4 percent in the county, according to the U.S. Bureau of Labor Statistics.

The U.S. economy lost 670,000 jobs per month from November 2008 to March 2009. The rate slowed slightly from April this year to June when there were 436,000 job losses per month.

Although the rate of job losses is slowing, it will not be enough to rekindle the office market.

But the unemployment numbers are really only a hint of the state of the market. Many persons have been furloughed or are working part time to accommodate employers who can only maintain them in this way as they ride out the recession.

This alone suggests the dramatic reduction in space needs.

There is another phenomenon at work, also, which is driving the numbers. It is the ratio of employee to square feet occupied.

Our studies have shown that this number has decreased during the last 25 years by 100 square feet, from a high in the 1980s of 250 square feet per employee to the current number, which may hover around 150 square feet per employee.

This is a gross measurement of everything in a tenant's space, divided by the number of employees in that gross space. It does not mean we are getting smaller. It means that our computers and their storage systems are taking the place of filing cabinets; and that voice mail is taking the place of receptionists; and that word processing and accounting software is taking the place of administrative intermediaries.

The result is smaller space needs.

Many companies have also subdivided their space into "showcase" vs. back office. The showcase space is for nice conference rooms, partners, fine art and the other accouterments to present to clients. The back office space is the no frills zone for employees. The net result is less space requirements, possibly in different locations and a net lower lease rate.

Transactions

The transaction market is down. In the last year, there have only been 335 transactions compared to 443 in the 2006 to 2007 period, before the downturn of the commercial market. Cap rates have been in the upward trend, up to 7.9 last quarter from 7.7 one year ago and 6.75 five years ago, reflecting lower revenues, higher vacancies and the prospect of more of both.

While stock values are down for the REITs and the publicly traded firms that specialize in the commercial markets, these holders of

commercial property are not mimicking their residential counterparts.

They are not capitulating and foreclosing.

Most will hold the properties through the recession, and beyond, and change a midterm holding strategy to a longer term one.

Properties that are in trouble with their lenders will mostly work out deals with those lenders, who typically will not have an appetite to become property managers.

In other words, there should not be a market debacle in the commercial sector, mostly because these are professional players, playing in an adult world where most loans were not fraudulent and mistakes are acknowledged.

In the big boys' world of commercial market holdings, mostly occupied by REITs, insurance companies, pension funds, and investment banks and their clients, the strategy will be to hold the course.

Conservative asset management strategies, however, will impact future values. Capitalization rates will creep up, reflecting lower incomes today and projected into the

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future. The era of "pro forma" projections of ever-increasing lease rates and occupancies is contrary to the movement of the market forces at play.

The financing market is in turmoil. The high leverage loan terms that were available through the CMBS markets until 2007 have been replaced by a loan environment that is expensive or nonexistent (not unlike the jumbo end of the residential market).

So expect a flattening of the valuation curve.

What does the immediate future hold? It's back to fundamentals.

Deals will be evaluated on current income, gradual increases in occupancies, and stable rent levels.

That is most likely to translate into a continued stagnation in the transaction market, offering little incentives for current owners to unload.

Many bought during the peak years. Selling now would be for a loss.

Despite the downturn, San Diego is a well-diversified economic region.

It will solidify and recover sooner than most. The real property volumes and values will eventually reflect this.

But the commercial market is not likely to be robust for many, many years.

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