COMMENTARY

Gary London >> COMMENTARY

New Economics of Commercial Real Estate Is in Retrofit

In a quest to discover a new economic proposition, at least one major office building owner has connected the dots. Hines Interests LP has transformed the formerly "Class B" office building known as Golden Eagle Plaza at 525 B St. in downtown San Diego into an arguably Class A superstar.

How did they do this? They took a still well-located, 22-story office building, refurbished it with a new lobby, elevators, controls and systems, replaced the cooling tower, put on a new roof, upgraded the lighting and HVAC system, and performed numerous exterior repairs, including redoing the curtain wall, and they achieved the new standard of LEED certification.

Paul Twardowski

"The cumulative of all of this is we made the building into a better functioning and appearing machine," said Paul Twardowski, vice president and partner of Hines, the building's owner that invested $10 million (not including tenant improvements) into the project. (In the interest of full disclosure, I am an investor in the Hines REIT.)

For Hines, the money they invested in upgrading Golden Eagle Plaza is less expensive than constructing a new building.

Even though Hines is a legendary builder of signature commercial structures (they completed La Jolla Commons office tower, located at the Interstate-805/La Jolla Village Drive intersection — also LEED-certified — in 2008), owning 181 throughout the nation, the economics of new construction do not work for the commercial markets at the present time. But the economics of purchasing existing buildings, and then retrofitting them, is very promising. As commercial devaluation takes hold in the market in the coming month, Hines will be seeking new assets to buy.

The current state of the commercial office market is dismal. Vacancy rates both in the region and downtown now stand at close to 17 percent. In downtown, where there is a total of 13 million square feet of office space, almost 2.4 million square feet is available for lease, by far the most ever. Nationally, the story is much the same. According to REIS Inc., a national compiler of commercial data, the national office vacancy rate is now 16.5 percent, the highest level in five years.

Much of this inventory locally and nationally is aging and obsolescent. Unless these mature properties are upgraded, the best tenants will look elsewhere when they seek additional space in the coming years in response to the anticipated growth in the economy.

Balance Of Power

Attorney Karina Juarez of the **Brown Law Group**, a specialist in commercial office leasing and contracts, calls current market circumstances a new "balance of power" where tenants have now gained the upper hand, including free rent and rent reductions.

"In the past, only anchor tenants with economic prowess were able to make economic and noneconomic demands (these range from dictating tenant mix, prohibited uses, parking availability and usage, percentage rent, common area maintenance charges, etc.)," stated Juarez. "But since the economic downturn, their expectations for decreased cost and improved amenities have been telegraphed to the market and landlords are responding."

Hines' retrofit strategy seems to be starting off well. One of San Diego's venerable, and large, law firms is moving to Golden Eagle Plaza. The firm of **Procopio, Cory, Hargreaves & Savitch LLP**, who were comfortably ensconced in their digs across the street in the Union Bank Building, have committed to 100,000 square feet in the building.

Maybe they were attracted by the promise to build a meditational garden. More likely, the best part of the deal was new space in more operationally efficient space.

Is it a precursor of things to come? Dr. Norm Miller, professor at the Burnham-Moores Center for Real Estate at the University of San Diego, has been conducting studies on the value of sustainability. To answer the question, "Does green pay off?," he conducted what is believed to be the first systematic analysis of property data to document the income premium associated with "green buildings."

By analyzing CoStar Group Inc.'s comprehensive database of U.S. commercial property, the study found energy-efficient, sustainable buildings on average operated at higher occupancies and achieved higher rents, two variables that directly relate to higher net operating income. The study also found that, on average, these buildings sold for a higher price per square foot compared with peer office buildings that were not Energy Star-labeled or LEED-certified.

In downtown San Diego, the only real choices for building owners are to retrofit or witness a building's diminishment of value. As Hines' Twardowski notes, "It's going to be awhile before constructing a building is prudent. Rental costs are not justifying new construction. Buying today at a low basis justifies the retrofit."

The idea is that you can take a building with good bones, underwrite a multimillion-dollar renovation and move the building up the classification echelon and make the building competitive.

No TARP Money

What is truly astounding is that of all the talk about "TARP" money — the government's Troubled Asset Relief Program — to stimulate the economy, an obvious place where it could do some good is on "Main Street," retrofitting these older buildings. Yet, precious few dollars have apparently targeted retrofits.

Instead, the money has been used to prop up the housing sector, either directly or through the banking institutions. It is arguable whether that is a good way to recharge an economy.

In contrast, it is simply not arguable that putting construction companies to work on these obsolescent buildings is ultimately good for the economy.

New Civic Center

Part of this reasoning is behind the city of San Diego's efforts to search for a solution to their antiquated and dangerous headquarters at 202 C St. by committing to negotiations with developer Gerding Edlen Development, which is proposing to build a public-private, sustainable-on-steroids showcase office building. Between the striking architecture, building efficiencies and sustainability, the structure would certainly attract tenants eager to be housed in this new-age environment, and probably for the highest lease rates attainable.

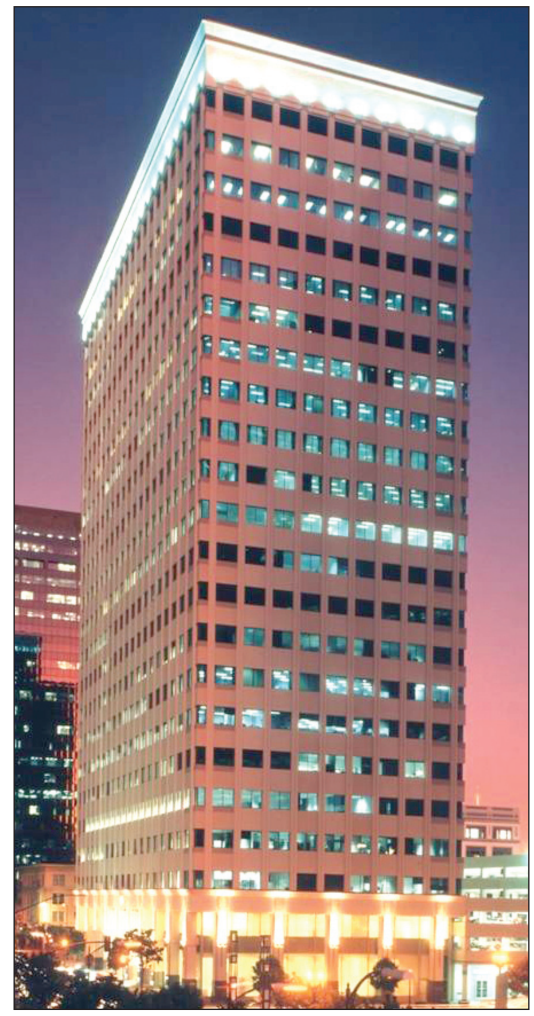

Photo courtesy of CoStar Group

Hines' investment in Golden Eagle Plaza is one example of the value that can be obtained by upgrading an existing structure rather than constructing a new building.

The city of San Diego as a public agency has to make choices that are fundamentally the same as those made by private businesses. They have to find the right balance between economics, business efficiency and the health and welfare of their employees.

I am certain that the answer does not lie in forcing business as usual in a sick, 50-year-old slum of a high-rise. If the city does not elect to construct the building, they certainly can use their leverage as a very large tenant to cause the retrofit of another building or buildings, presumably in another structure along downtown San Diego's B Street corridor.

Maybe they can move into Procopio's old space!

It is certain that the next wave of commercial development does not lie in "new" construction. The economics point to retrofit.

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