COMMENTARY

Editorials, letters, columns and other opinions

The Changing Face of the County's Office Market

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Gary H. London

The commercial office market is moribund and will remain that way for the foreseeable future. That's no news to anyone reading this newspaper.

Yet, when the economy eventually recovers and begins to produce new jobs again, it is unlikely that the pace of office demand will ever match the demand level of the past 10 years. Emerging efficiencies and flexibility in the use of office space and adaptive re-use of some types of commercial space will reduce demand for traditional high-value office space. Taken in combination, these factors will change the face of the commercial office market.

Here is a snapshot of the current San Diego County office market:

Of the total 111.4 million square feet of office space countywide, 17.1 million square feet, or 15.4 percent, is vacant. This is the highest vacancy in 16 years in San Diego.

Another 3.8 million square feet of office space is likely vacant but not on the market because it is still under lease by companies that have no current use for that space.

With vacancy comes lower lease rates and, in fact, the county's average rates are down 15 percent, to a regional average of $2.26 per square foot per month. The softest markets include downtown and University Towne Center, but all submarkets are experiencing decline.

Values of commercial space have dropped as much as 40 percent, reflecting these lower revenues and occupancies.

The market will take some time to absorb this inventory. Eventually the local economy will expand, employment will grow and these new employees will fill the vacant space. In time, lease rates will rise again.

Predicting Demand Based on Trends

In 2000, approximately 1.3 million people were employed in San Diego, 399,000 of whom were employed in professions that traditionally utilize commercial office space. At the time, there was 85.3 million square feet of occupied office space in the region, calculating to 214 occupied square feet of office space per employee.

During the next eight years, office employment grew to 462,000 and the amount of occupied square feet of office space rose to 93.7 million square feet. This calculates to a reduction in space requirements to 203 square feet per employee.

The San Diego Association of Governments is projecting employment increases between 2008 and 2020 to be approximately 104,000 people, 31,000 of whom are likely to be employed in professions that traditionally utilize commercial office space.

Here is the rub: I project that the average utilization per employee will fall from the utilization high water mark in the mid-1980s when the average was 250 square feet per employee to a range of 180 to 200 square feet by 2020. And this is conservative. If we actually calculate the change during the past eight years, the trend is even lower: 130 square feet per employee.

Future Demand for Office Space

	2000	2008	2020*
Total Employment	1,322,200	1,501,080	1,604,615
Office Employment	398,802	461,507	492,906
Occupied Office Space	85,326,254 S.F.	93,708,756 S.F.	99,674,488 S.F.
Office S.F./Employee	214 S.F.	203 S.F.	202 S.F.
Increase in Office Employment			31,399
Future Office S.F./Employee			190 S.F.
Incremental Demand for Office Space			**5,965,732 S.F.**

Sources: The London Group Realty Advisors, SANDAG, CoStar *Forecasted

Over the next 10 years the additional 31,000 people employed in traditional commercial office space are projected to occupy 6 million square feet, or approximately 190 square feet per employee, continuing the downward trend in the demand for office space. The accompanying table details this trend.

Impacts on Office Space

We are not out on a limb with this projection. Our market studies have repeatedly demonstrated consistent reductions in space needs per employee during the past 25 years, consistent with national trends. The reduction is mainly based on the following key factors:

- Computer hard drives have replaced file cabinets and bookshelves, dramatically reducing the document storage footprint requirements for most offices. This is the most important factor contributing to a reduction in demand for office space.
- Compact desktop and laptop computers have replaced old-style computers, taking up less leasable space.
- Receptionists have been replaced by voice mail. Administrative positions have been replaced by technological solutions.
- There is a growing trend to use the home as a part-time workplace.
- Lastly, there is a cultural change in the thinking about office space: For instance, when KPMG relocated its offices from downtown to UTC in 2009, its formerly large partner offices were downsized to accommodate an open office configuration, resulting in better overall space utilization.

When occupancy begins to rise, the first reaction in the marketplace will be the end of the "tenants" market, a rebalance of supply and demand, followed by scarcity.

The Next Wave Is Retrofit

Here, too, we will see a change. To attract new tenants, much of the existing inventory of office space in San Diego County will be renovated and retrofitted to achieve higher lease rates and attract new occupants. We estimate that 72 percent of the regional office inventory is classified as "B" or "C" space, or even lower quality. These classifications, which include both older buildings as well as those buildings in less attractive locations, translate into lower lease rates and occupancies.

To be competitive, a good portion of this space will require upgrading and retrofitting in unprecedented ways, including:

- Leadership in Energy and Environmental Design, or LEED, certification, a classification index that generally grades energy efficiency and other "green" components of a building structure.
- Incorporate the latest technology and information systems. This might include upgraded high-speed computer cabling.
- To be competitive, office buildings are likely to offer more amenities for the care and nurturing of their occupants, such as those that involve relaxation, services and food.

Normally, new office development would not occur until vacancy drops to under 10 percent. A straight line calculation of future office space absorption suggests that this will not be achieved for nine years, although realistically we should see meaningful new development proposals in five to seven years.

Nontraditional New Development

The candidate locations for new high-rise space certainly includes downtown where there are planned and targeted high-premium bay front or bay view locations at the Embarcadero and Pacific Highway, as well as coveted and potentially available spaces in the UTC area. There are many pending proposals for high-quality projects in UTC, Carmel Valley, Sorrento Mesa and elsewhere.

But what excites me is what I see as a growing trend to include new office spaces in nontraditional locations and as part of mixed-use developments.

Many of these communities will experience excess developable properties that were formerly strip commercial buildings, old shopping centers and obsolescent industrial parks. The transition away from horizontal, tilt-up industrial buildings will include their redevelopment as office space. The transition of older, outdated retail centers should present opportunities for new office locations.

Many new projects will be purchased by companies rather than leased, a tradition in single-use buildings occupied by larger firms.

The future for the commercial office market will reflect our regional economy: It will house many small and medium-sized businesses, as well as the technology companies that are expected to make up a significant portion of our future business community. The difference is that there will not be as much new commercial office development built in the future as there has been in the past in response to the changing patterns in demand for office space.

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