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Most of the Worst Behind for Orange County Office Market

Negative net absorption exceeded 2 million square feet in 2009 as the sales volume continues to decline

By JULIE NAKASHIMA – CREJ Staff Writer

"More of the same" is how experts in the Orange County office market describe their expectations for 2010.

On the leasing side, statistics from a variety of firms tell the story: According to **Voit Real Estate Services**, negative net absorption of Orange County office space more than tripled to 2.9 million square feet last year. The fourth-quarter negative absorption alone topped that for all of 2008.

CoStar Group Inc. pegged the county's 2009 negative net absorption at 2.2 million square feet. Not to be outdone, **Delta Associates**, the research subsidiary of **Transwestern**, put Orange County's 2009 absorption at negative 3.14 million square feet. Vacancy rates ranged from 14.5 percent to 17.5 percent, with Voit pegging the availability rate including sublease space at 23.4 percent.

Craig Ersek, executive vice president of **Essex Realty Management Inc.**, said 2008 was not a great year. But 2009 was when one really started to see degradation in the marketplace, both from a leasing standpoint and also from a valuation standpoint.

For 2010, he's hopeful but not overly optimistic about rate stabilization.

"I think we'll continue to see more of the same," Ersek said. "We're not too bullish. What we're hoping for is the degradation of the market to slow down."

Indeed, between space being put back on the market and the FDIC rejecting re-leases, 2009 was a tough year, said Jeff Ingham, brokerage director in the Orange County office of **Jones Lang LaSalle**.

Nonetheless, from a psychological perspective, he feels that the beginning of the New Year marked a turning point.

"The public perception is that the majority of the worst is behind us," Ingham said. ""Not that we're going to recover any time. We're going to be dabbling at the bottom for a while."

He sees leasing activity picking up, but rental rates will continue to drop by anywhere between 5 percent and 10 recent.

"Our vacancies are well over 20 percent," Ingham said. "We need to absorb some of that vacancy before there'll be any positive rental growth. We need job growth to increase the occupancy levels and take it from what is currently a tenants' market into more of a landlords' market."

Ersek echoed that thought.

"I don't know if the crystal ball is cloudy, but the reality is that until jobs are being created, there's just not going to be a lot of positive absorption in the market," he said. "Even when their businesses finally do turn around, we don't think they're going to be hiring people anytime soon."

The outlook is not encouraging for robust job growth. According to the state's Employment Development Department, the county's unemployment rate rose to 9.4 percent in November, up from the year-ago estimate of 6.1 percent. The county lost 53,000 payroll jobs between November 2008 and November '09.

Landlord Strategies Varied

There is a lack of consistency in the market right now, according to Ingham, who pointed to a "big discrepancy" between two types of landlords competing for tenants.

"As you look at different landlords, the pricing is a bit squishy," he said. "We have certain landlords that are in good financial positions and they will go to a certain rental rate. There are certain landlords who can't go below a certain number because of their loan and are holding firm their rates. Other landlords are giving away the farm because they may own the building for cash."

Ingham said the Airport Area and South County submarkets have been hit particularly hard by this down cycle. Voit puts the available rates for those markets at 25.7 and 24 percent, respectively, at the end of the fourth quarter. The South County market of Foothill Ranch had the highest availability rate anywhere in Orange County at 43 percent, followed by Irvine Spectrum at 30.9 percent.

"Aliso Viejo has been hit pretty hard with tenant defaults and give-back space," Ingham added.

On the positive side, he said the Fashion Island area in Newport Beach is doing well, while the Irvine Spectrum area has recovered the most. The West County, which includes cities such as Cypress, Fountain Valley and Huntington Beach, boasted the lowest availability at 14.9 percent.

But Ingham said difficulties are scattered throughout the entire county.
"All the markets are seeing pretty significant vacancies," he said.

George Thomson, a senior vice president with **Lee & Associates**, said he's feeling a bit more optimistic now than the same time last year.

"I think that we're approaching the bottom of the trough," Thomson said.

Flight to Quality

Activity has picked up overall and there seems to be more velocity of tenants in the marketplace - in particular, tenants that are looking to take a step up in their class of building, according to Thomson.

Ingham agreed.

"There has been a flight to quality as companies are choosing to move from warehouse buildings to Class A buildings," he said.

What the market needs, Thomson said, is industry growth internally or inbound tenants. He cited "rumors" regarding several large requirements from outside Orange County that are looking in the marketplace.

"That would create some momentum in the county and bring in some inbound jobs," Thomson said.

According to Ingham, the Gas Company is looking for 150,000 square feet in central Orange County. Sage Software is looking for 100,000 to 120,000 square feet, and Mindspeed has been in the market for about 100,000 square feet.

In the office market, he noted, once tenants get above a certain size threshold there are fewer options out there.

"Right now, if you're a 20,000- to 40,000-square-foot tenant, you've got 30 to 50 options in the Airport Area. When you get over 60,000 square feet, you have probably less than a dozen buildings or so."

Five years ago, someone needing 60,000-plus square feet would have been limited to doing a renewal and one or two alternatives, he added.

One trend that Ingham doesn't see going away is that companies are leasing much less space than they did previously because of the greater efficiencies are work-at-home programs.

Orange County historically had been dominated by small tenants, but "they really don't tend to move the needle," Ingham said,

The types of tenants he foresees being the more active this year,, he said, are life science and medical device manufacturers, as well as a fair amount of law firms. But tenants still are struggling and defaults remain an issue.

Ersek said Essex manages a couple million square feet of space in Orange County, comprised primarily of two- to three-story "woody walkup" buildings to multi-tenant business parks with large office components. Much of the tenant base is composed of small entrepreneurial, mom-and-pop businesses, Ersek said. At this point, most of the marginal businesses are gone, but even the tenants who had been doing well now are starting to seek rent relief.

A little bit of "gamesmanship" goes on, as tenants who have a couple of years left on their leases want to see where the rates are.

"Some are angling for better deals, but, for the most part, you can discern who's struggling and who's not," Ersek said.

According to Ersek, there's a big spread between asking rental rates and the "whisper" rates where deals actually are being done.

"Landlords are hesitant to advertise the fact that their rates are down," he said. ""They're maintaining that asking rate as high as possible.

In Essex Realty's office management portfolio, Ersek said office occupancies have fallen from as high as 95 percent to the 70 percent range now. Some buildings that were in the process of being rehabbed when the market downturn caught them are in the 60 percent range, he said.

Rents are off 30 to 40 percent, or from $2.20 to $1.65 per square foot per month. "I don't see a floor yet,," Ersek said. "It's like anything else; it's supply and demand. There's a ton of supply out there and not a lot of demand."

On the positive side, he believes vacancies will increase only incrementally this year, which is a good thing as tenant distress also takes a toll on property managers.

"They look like they've been beaten," Ersek said. "It's tougher to manage a building when you're constantly dealing with tenants who are unhappy because their businesses are struggling. It takes a lot more energy and a lot more skill sets."

Data Points Being Made

On the investment side, the Orange County market received a few much-needed "data points" this past year. Depending on which side of the table they're on, however, the news might not be what some people want to hear. Sales of 3 MacArthur Place in Santa Ana, 3161 Michelson in Irvine and 3501 Jamboree in Newport Beach, the former headquarters of defunct thrift Downey Savings, underscored the market's precipitous plunge in values.

In total, $789.7 million in office properties valued at $5 million or more traded in 2009, according to **Real Capital Analytics**. That's down from $924 million in 2008 and $6.8 billion in 2007.

Brokers expect more such sales to take place this year as lenders finally stop kicking the can down the street. Ingham sees a pickup in investment activity this year but not an increase in prices.

Michael Kane, a senior vice president in the Newport Beach office of **CB Richard Ellis**, said Orange County was one of the most active submarkets in Southern California for office sales in 2009. Kane was one of the brokers who represented **Tishman Speyer** in selling 3 MacArthur last year. Looking at the market as a whole, he said, activity runs the spectrum from bargain-basement distress sales to purchases of well-leased properties fetching $300 per square foot.

"There is a tremendous amount of capital looking to purchase in Orange County right now," Kane said. "They see Orange County as a great opportunistic buy right now."

Jack Mahoney, executive vice president of 3 MacArthur Place buyer **Highridge Partners**, admitted the Santa Ana building is "not in the center of the target" of the Orange County market.

"You can say there are 'Gucci-er' locations," Mahoney said, but "That's a great building. It's very nicely built and it's something we felt that we could lease and manage effectively at a great price."

Highridge is looking to acquire additional properties in primary office locations, he said, although underwriting rents and occupancies is challenging. Orange County, particularly the Airport Area, is one market the company likes very much.

"That's an area that tenants in general want to be," Mahoney said. "When the market is this disturbed, then I think we have to stay in markets that are the first-choice markets."

Ersek expects to see lenders become more aggressive this year because to date they haven't been. Landlords who have purchased buildings with debt in the past three or four years and whose cash flow have been severely restricted in the downturn will be the ones to watch, he said.

But the people who are able to buy from the banks or the distress sellers will be able to be more competitive, which will put downward pressure on rents.
One thing in 2010 that will be new from an opportunity standpoint will be accelerated sales activity and change in ownership. Ingham said Orange County historically has had just a few different landlords for Class A buildings.

"In the next 12 to 24 months," he said, "there's going to be a lot of changeover in ownership, which will provide new opportunities from an agency brokerage perspective."

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