

Job Losses Drive Outlook for Office Sector

Unemployment expected to exceed 12 percent statewide

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Forecasters who peered into their crystal ball early in 2009 and predicted the entire year would be a dismal one for commercial real estate probably are going to be right.

Not even the most optimistic market watchers are expecting a quick recovery at this point. "The economy is out of intensive care, but make no mistake, it is still very sick," said David Shulman, a senior economist with the University of California, Los Angeles' **Anderson Forecast**, during a June 16 forecast.

The Anderson Forecast economists are predicting the economy could begin to recover in third-quarter 2009 but with minimal growth in gross domestic product through first-quarter 2010. For the remainder of 2010, GDP only is expected to grow 2 percent.

"If you ask what is going on in the office market, I would have to say look at what is going on in the economy," said Whitley Collins, a senior managing director at **Jones Lang LaSalle** in Los Angeles. "Unemployment is the biggest issue in this business. It certainly drives demand on the office side."

The Los Angeles office market probably will bottom in mid-2010, but the loan maturities coming due for office building owners in 2011, 2012 and 2013 could result in problems for years to come, Collins said.

The jobs forecast for California doesn't provide much room for hope either.

Statewide unemployment is expected to grow to 12.1 percent in fourth-quarter 2010, averaging 11.5 percent for the year, according to the Anderson Forecast. The California economy will grow in 2011, but it will not generate enough jobs to drive the unemployment rate below double digits until year-end, the forecast stated.

"Real estate deals have gotten better than they have been for a long time, but tenants are uncertain about the future," Collins said. "If you don't know where you are going to be in 12 months, do you sign a five-year lease? You could do a smoking deal right now, but if your business changes three years from now it could turn out to be a bad deal."

With construction starts down dramatically and investment deals relegated to a few distressed sales or deals below \$10 million, leasing appears to be the only sign of life.

Building permits for new construction in the San Francisco and Los Angeles office markets are down 75 percent since last summer and there is very little in the pipeline after 2009, according to a joint survey released in June by the UCLA Anderson Forecast and Los Angeles-based law firm **Allen Matkins Leck Gamble Mallory & Natsis LLP**.

Looking to Leasing

Even with rental and occupancy rates falling, there is a realization that the previous building boom in these two markets was relatively small and it will not take a huge rise in demand to force vacancy rates back below 12 percent, the survey states.

Lack of expected completions in 2009 bumped San Diego up four places to the No. 8 slot in **Marcus & Millichap Real Estate Investment Service's** rankings of the 43 top office markets nationally. Office completions in the San Diego market as a percentage of inventory make it among the lowest, according to Marcus & Millichap's 2009 Annual Report.

The Inland Empire likely is the only market in the state that can't point to lack of new supply as a reason for hope. Office inventory there expanded by 5.9 percent during second-quarter 2009 with the completion of 1.1 million square feet, according to a Marcus & Millichap office report on the area. The Inland Empire's vacancy rate is forecast to rise to 30 percent this year, making it the second-highest in the nation, according to the reports.

In the Silicon Valley, pent-up demand finally is resulting in signed leases, said Anne Ralston, senior vice president with **Cornish & Carey**, in the brokerage's first-quarter 2009 report on the South Bay office market.

Vacancy rates in the Silicon Valley grew to 18.1 percent in first-quarter 2009 from 12.6 percent in first-quarter 2008, with asking lease rates declining by 10 cents to \$2.75 on a monthly basis, the report states.

"The only landlords that are successfully completing deals are the ones that have gotten down in the trenches and have substantially lowered their asking rates," Ralston said. "In general, each tenant is seeking to achieve the new, lowest deal in the market. Every new deal seems to have more concessions in it - whether it is free rent, more tenant improvement dollars or phase-in on short-term deals."

The fallout from tenant consolidations in the San Francisco market has resulted in the worst quarterly performance since the dot-com collapse, stated a **Grubb & Ellis** report.

Macy's West and **Charles Schwab** vacated a combined 600,000 square feet of headquarters space in San Francisco during first-quarter 2009, bringing the vacancy level to 13.8 percent, the report stated. The availability of sublease space rose to 2.3 million square feet by the end of first-quarter 2009 from 1.9 million square feet in the fourth quarter, and average asking rents for direct space have softened to \$38.08 for Class A space, the report stated.

"In general, things are getting much better - fourth-quarter 2008 and first-quarter 2009 were the slowest quarters we have had on record," said Scott Harper, a senior vice president in the San Francisco office of **Colliers International**. "Leasing activity started to pick up in the second quarter, and I expect it to pick up during the second half of the year."

In Sacramento, vacancy reached 15.7 percent by the end of the second quarter and is expected to peak at 17.2 percent by year-end, said Garrick Brown, research director in the Sacramento office of Colliers International.

"We actually did record some positive occupancy growth this quarter, despite the increased vacancy rate," Brown said. "This is because CalSTRS occupied its new 400,000-square-foot building in West Sacramento, and we had some modest occupancy growth downtown."

The gains from the CalSTRS building and the downtown growth combined to outpace the losses elsewhere, Brown said. The Sacramento market absorbed 100,000 square feet of space during the second quarter, but Brown expects absorption to be negative for the remainder of the year, he said.

In Southern California, vacancies also are rising and most markets have negative absorption. "In Los Angeles, vacancy is 14 or 15 percent, which is far better than San Diego or Orange County, where it is 20 percent," said Kevin Shannon, a vice chairman with **CB Richard Ellis** in Los Angeles.

Moderate Demand

Companies are downsizing, so when leases expire they are reducing office space, Shannon said. Landlords' favorite deals are a three-year as-is renewal with no tenant improvements because the access to capital for improvements is difficult, he said.

[With tenants wary of the future and some landlords fighting for their lives, a property manager's job is not easy, said Craig Ersek, a vice president in the Irvine office of **Essex Realty Management**.](#)

["Some tenants have this attitude that the landlord needs to take a big haircut," Ersek said. "Some owners are doing fine, but others are leveraged and have to clear a certain amount to make their mortgages."](#)

Bert Dezzutti, who runs Southern California operations for **Brookfield Properties Corp.**, said factors such as Fox Interactive's decision to not move into the 421,000-square-foot space in **Lincoln Properties'** office development in Playa Vista is creating some softness in the West Los Angeles market. But Brookfield is benefiting from supply constraints, particularly in downtown Los Angeles.

"I would characterize downtown Los Angeles as being one of the better performers since the recession took hold in fourth-quarter 2007," Dezzutti said. "We are experiencing moderate demand. Three landlords are vying for tenants within the market, but there also has been in-migration."

Brookfield signed leases with two law firms to occupy space in its Bank of America Plaza building in the first quarter: a 90,000-square-foot lease with law firm **Kirkland & Ellis LLP** and another 55,000-square-foot lease with **Seyfarth Shaw LLP**.

Collins, however, thinks the vacancy levels will be much higher than anticipated this year because of what he calls phantom space created by employers sitting on vacant space in the hope of rehiring laid-off employees.

"If a law firm lays off 500 employees today, it doesn't mean the real estate is on the market today," Collins said. "It would take 30 days to get the employees out, and then six months to make the decision if they want to sublease the freed-up space."

Acquisition Opportunities

If tenants aren't signing leases, vacancy levels rise, making it harder to sell buildings in an era when debt is not readily available and lenders are conservative.

The sales volume has fallen so precipitously over the past 18 months that Shannon said he has been out of business for 12 months.

"In Los Angeles, we had \$53 million worth of deals this year through May," Shannon said. "If you look at our peak years, we had \$14.9 billion in 2007 and \$14 billion in 2006. That means we are down almost 99 percent."

The sales volume for commercial real estate declined by 70 percent nationally in the first quarter of 2009 over the same quarter the previous year, according to a report produced by **Falcon Real Estate Investment Company LP**.

The much-talked-about delta between the bid-ask price hasn't been that much of a factor because there haven't been that many properties for sale, said Paul Paradis, a senior vice president with **Hines**.

"We are just beginning to see acquisition opportunities," Paradis said. "We are hoping that the number of properties being offered in the market will start to grow. We are also hoping that the debt markets will stabilize to allow for some reasonably priced and termed debt to be available." Paradis wouldn't predict what capitalization rates will be, but the Marcus & Millichap report anticipates they will exceed 8 percent in 2009 on a national basis while assets in certain secondary markets already have reached 10 percent.

In Orange County, the first to feel the subprime mortgage pain because of its concentration of home mortgage firms, transactional activity is starting to pick up as distressed assets are re-appraised, said Stefan Rogers, a senior associate in the Irvine office of **Voit Commercial Maguire Properties**, a Los Angeles-based real estate investment trust, has sold several office buildings, further helping to set pricing.

Maguire acquired a number of properties from **Blackstone** at the height of the market. Facing debt maturities from those purchases in an environment where replacement debt has been largely unavailable, it began selling Orange County assets in mid-2008. It has begun to have success unloading assets in recent months.

The REIT had about \$259 million of debt maturing in 2009, primarily consisting of construction loans for the Lantana office project in Orange County and 3161 Michelson. It was able, however, to sell 3161 Michelson, located in Irvine, to an affiliate of the **EMMES Group of Companies**, on June 15. The building was 61.9 percent leased.

The Michelson sale eliminated the REIT's entire obligation under the project loan and significant master lease obligations, said Nelson C. Rising, president and chief executive officer of Maguire. The building sold for just under \$300 per square foot, which sounds high considering the building's occupancy level, but it also is one of the most prominent Irvine office buildings, Rogers said.

Turning in the Keys

Lack of credit has companies considered stalwarts in the office industry saying "never say never" about whether they could ever be giving the keys to a property back to the bank.

"We are seeing a lot of people trying to renegotiate," Collins said. "At a certain point, if you bought the building in the last four years, there is a 99 percent chance you have no equity. If you have a no-collateral loan and get in a situation you have to hand the keys back, you will do it. There is no ego involved there."

A Hines official quashed rumors that the troubled 333 Bush Street, the 350,000-square-foot building in San Francisco that formerly housed the defunct law firm **Heller Ehrman**, has been taken back by **Brookfield Real Estate Fund**, a sister company to Brookfield Properties that owns the debt on the building.

"The Heller Ehrman bankruptcy did severely impact that property," Paradis said. "We are in ongoing discussions with the lender to restructure the loan. At this point, we are still running the building."

Be it a servicer on a commercial mortgage-backed security or a bank, it is never an easy decision to give a building back, Paradis said.

"I can't speak for others, but for Hines, regardless of what the structure is, we would never make

that decision lightly," Paradis said. "It is a very difficult decision to give a property back to a lender, but there may be times when that move is the only alternative."

Despite talk of "green shoots" indicating seedlings poking through the ground to herald the beginning of a recovery, most commercial real estate professionals seem resigned to a slow and painful recovery.

"Eighteen months ago we thought it would come fast and get corrected fast. We were expecting to see a significant number of bankruptcies," said Kevin Ehrhart, a partner with Allen Matkins, who spoke at the Anderson Forecast conference in June. "Now we are thinking that it will drag out for a long time and we will have a slow correction."

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