

Feb. 08, 2010

Employment Stability Will Sustain S.D. San Diego Office Market in 2010

Investors continue to look for deals as properties fall into distress, but don't expect a significant increase in the region's transaction volume

By MANDY JACKSON --CREJ Staff Writer

While landlords attempt to fill a rising number of vacancies at falling rental rates, investors will continue to scour the San Diego office market for good buys in 2010.

Employers may add few jobs this year, but they are not expected to shed workers in the same high numbers that contributed to modest absorption in 2009.

Still, buyers anticipate discounts on the few buildings that do come to market as distress grows in the office sector.

Eric Northbrook, executive director at **Cushman & Wakefield** in San Diego, said landlords and brokers are more optimistic in 2010 than they were in 2009.

"It's all dependent upon job growth and we need to see the job growth to see true absorption," Northbrook said. "When you go into a certain market and you're a user under 10,000 square feet there are more spaces than you know what to do with when there are 50 to 75 choices available. When you have that many spaces available in that size range it takes an awful lot of good news and jobs to fill those spaces."

The unemployment rate in San Diego County reached 10.1 percent in December, well below the California unemployment rate of 12.1 percent. The county shed 43,100 jobs between December 2008 and December 2009, according to the state's Employment Development Department. The professional and business services jobs category recorded the greatest

year-over-year decrease with 9,300 jobs cut.

Northbrook said most companies that were hunkering down and tightening budgets in 2009 to get through the recession completed layoffs and other cost-cutting measures last year and aren't expected to shed additional jobs in big numbers in 2010.

"Leasing seems to be picking up a little bit, but we're only three weeks into the year," he said. "Everybody thinks 2010 is the year things are going to pick up, but it's too early to tell yet."

Positive net absorption of 372,791 in the fourth quarter gave 2009 what it needed for a positive annual net absorption total of 257,898 square feet at year-end, according to Cushman & Wakefield. Still, the brokerage reported that direct vacancy reached 15.4 percent in the fourth quarter, up from 14.4 percent a year earlier. Asking rents declined in the same period to \$2.32 per square foot per month from \$2.58.

Brian Driscoll of San Diego-based brokerage **Cassidy Turley BRE Commercial** said the local office leasing market seems to be stabilizing, but rents still are in decline.

"Rents shouldn't drop a whole lot more than they already have, but they'll probably stay down at least another four to six quarters," Driscoll said. Cassidy Turley BRE reported that office rental rates dropped to \$2.41 in the fourth quarter from \$2.69 a year earlier. Direct vacancy dropped 160 basis points in the past year to 17.4 percent in the fourth quarter, rising to 21.1 percent with sublease space included, according to the brokerage.

Driscoll said the reversing trend of negative net absorption probably has to do with pent-up demand for space, bargains available in the marketplace and expiring leases, rather than job growth, which continued to decline and add to vacancies throughout 2009.

"The slowdown in construction has and will ease the upward pressure on vacancy going forward," said Matt Root, chief investment officer at Los Angeles-based real estate investment trust **Pacific Office Properties Trust**.

Only 356,887 square feet of office product is expected to be delivered in 2010, which is 70 percent less than the amount under construction a year ago, according to Root.

Rich Simons, partner at San Diego-based **Sudberry Development Inc.**, said he expects office vacancy to climb during the first half of 2010 then level off. Simons predicted that rent growth will not start until 2011 with a possible 6 percent to 10 percent spike in 2012 due to a lack of new construction for the foreseeable future. He estimated that it could be three to four years before office development begins in San Diego County again.

Tenant Retention

To attract and retain tenants today, landlords must maintain high-quality and technologically advanced properties, thoroughly understand the market and be able to negotiate competitive leases that work for both the tenant and the building, Root said.

Stacey Hansen, senior property manager in San Diego for **Essex Realty Management Inc.**, said she has seen very little if any interest in leasing office space in the region's North County submarkets.

"I think most companies are still evaluating their internal financial structure and determining if now is a good time to downsize or take advantage of the lower leasing rates being offered in the same or different buildings," Hansen said.

Colliers International, which reported 16.5 percent vacancy in San Diego County as of fourth-quarter 2009 that rose to 17.8 percent when including sublease space, noted vacancy as high as 30.2 percent, including with sublease availability, in the North County city of Carlsbad and as low as 5.8 percent in the Uptown area of central San Diego.

To hold on to and attract tenants, Hansen said Essex has seen its landlords provide reduced short-term lease rates, larger concessions, tenant-improvement allowances, capped operating expenses, smaller suites for tenants looking to reduce their footprint and other lease modifications and incentives.

Hansen said she hopes demand for office space improves by mid-year, but she doesn't anticipate rental rate increases until after 2010 and even then rent increases are likely to be moderate until more positive economic news helps lift market rates.

"Rent growth has not returned yet, but we have seen rents stabilize," said Hack Adams, senior vice president of leasing with San Diego-based **Westcore Properties**.

"I believe vacancy will continue to stabilize this year. Absorption will be positive, but still off of historical average absorption numbers."

Chris Pascale, senior vice president at **CB Richard Ellis** in San Diego, said there was a surge in leasing activity toward the end of 2009, which made what was a very tough leasing year much better.

"The flight to quality continued with Class A product experiencing positive net absorption and Class B bearing the brunt of the negative net [absorption]," he said.

Certain submarkets have bottomed, but Pascale expects that they will bounce along the bottom for the first half to three quarters of 2010 before there is any appreciable rent growth.

"We are tracking more tenant activity now - twice as much - as the same period last year," he said. "Hopefully it is real demand."

Adam Robinson, principal in the Carlsbad office of **Lee & Associates**, said he's showing more space to tenants in 2010 than in 2009, but the activity may not lead to signing leases in new buildings because most tenants in 2009 ended up renewing their existing leases rather than pay for the expense of moving to new space.

"A lot of times, when we take these tenants out into the market, it's really just to scare their landlord into a good renewal rate," he said. "When good deals come up, tenants don't have the money or they're not ready. Things just aren't lining up yet."

- E-mail MJackson@DailyJournal.com