

**Message from Jason:****Why office rents are unlikely to increase in the short term****By JASON HUGHES**

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What a difference a few months can make in the world of commercial real estate.

Earlier this year, the national commercial real estate brokerages' spin machines were churning out predictions that San Diego commercial office rents would surely rise in 2006. One brokerage especially out of touch with reality stated in its market forecast: "Landlords and investors will be increasing rental rate in order to maintain or increase their income flow. ... Tenants are anticipated to pay the increased rental rates. ... Suburban San Diego Class A office rents to rise 10 percent or more." And on and on.

Rental rate increases are inevitable over a period of time, but there have been a number of reasons why 2006 was not to be the year for the predicted (and hoped for) hikes. Such reasons should be intuitively obvious to anyone who understands the basics of supply and demand -- especially in light of the fact that lots of new supply has come onto the market over the last two years.

What the landlord broker braggarts neglected to take into account in their bully predictions is the most important indicator in our local economy: the number of company formations and financing. San Diego is by no means rife with a myriad of major companies moving into town. Gateway Computers was one notable exception as are some others, but they are precious few in number.

Instead, San Diego's role as a center of research and innovation means that our region incubates or grows our own companies, from small units to larger entities. They are not large-space users. Add to that the fact many of these companies merge or become acquired while others leave the area because of our region's sky-high cost of living. Just some examples make the point: Buck Knives moved to Idaho; People First/Capital One hightailed it to Texas; IPivot/Intel relocated to Oregon; and Memec/Avnet closed down its San Diego operations. Not to worry: San Diego will grow more, but it takes time.

Meanwhile, the lack of new company formations and financing conditions hardly create any upward pressure on rents.

Yet another factor not taken into account in the bogus predictions from landlord brokers is the relatively narrow strands of growth that we do see. Qualcomm is a great example of a single company with an inordinate impact on our entire region. What do you suppose the impact on the local commercial real estate market would be if Qualcomm's growth were to slow down or reverse? Qualcomm sneezes and San Diego's commercial estate market catches pneumonia.

Those companies that do, in fact, expand in San Diego do so at the mercy of the real estate market and interest rates. Home builders, mortgage companies and financial services firms expanded in recent years, thanks to a 45-year low in mortgage interests and a period of record real estate appreciation. What do you suppose is happening now that rates have begun to climb ever so slightly and real estate values are leveling, and in many cases, dropping, for most of this past year?

So much of our economy in the San Diego region depends on sustained levels of significant growth. Any slowdown, however slight, greatly affects many of our region's economic segments -- in particular, commercial real estate. The cooling economy this past year is hardly the basis for fully occupied office buildings, much less the hefty rent increases predicted by landlords earlier.

The last "nail in the coffin" of the rental increase scam has been the desperate attempt on the part of landlords to pass along the absurd prices they paid for buildings to their tenants. Over the past few years, institutional investors have continuously bid up the price of commercial office buildings in San Diego without any regard to the viability of rental rates being fetched in the market. Not surprisingly, these owners began seeking to improve their returns by raising rents, predicated on the bloated prices they paid for their buildings. Problem is, the "pass-along" trick doesn't work; rents don't follow prices as landlords and their broker chums have learned in recent months.

While some tenants may have fallen into this trap in the short term, basic supply-and-demand economic principles have prevailed. Savvy tenants now recognize the landlords' dilemma and are rightly exercising their newfound leverage.

Don't misunderstand; San Diego is not the Seattle of the 1970s when Boeing's misfortunes gutted that city's

economy. San Diego will continue to grow and thrive as a center of innovation, tourism, retirement and technology. Rents will rise over longer periods of time in response to increased demand that is fueled by sustainable employment -- not by bloated prices paid for office buildings.

Meanwhile, I've said it before but it bears repeating: Office tenants in the San Diego region have opportunities to lease office space at fair and competitive rates and under far more favorable conditions than have been the case for quite a while.

It's about time.

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