# Opportunities abound

Profiting from 2007's soft commercial real estate market **Interviewed by Leslie Stevens-Huffman**

When searching for commercial real estate space, CEOs have been taught that vacancy rate indicates how soft the market is.

"But vacancy rates are not what they appear to be," says David Marino, principal and executive vice president of Irving Hughes. "We need to stop talking about vacancy rates and start talking about availability rates. Availability rates will show that the overall market is much softer than landlords and their brokers would have you believe."

A smart CEO also needs to understand the broader picture — including time on the market, sublease space and net absorption — to pull together a more comprehensive view of the marketplace.

*Smart Business* interviewed Marino to see how CEOs can improve their company's bottom line through negotiating more favorable lease rates and obtaining better concessions when leasing space.

**David Marino**
Principal and executive vice president
Irving Hughes

**Exactly why is availability the better measure of the market?**

Vacancy rates are just that — a measure of unoccupied space. However, when a company seeks facilities, it does not look at vacant space, but rather at all of the space on the market — what is available, and not what is vacant.

Vacancy rates provided by the same brokerage firms that are promoting landlords' listings do not count available space due to pending relocations. The listing brokerage community also conveniently ignores sublease space, because that space is not technically vacant — all 4.1 million square feet at least count, which is up from 3.3 million just a year ago.

The spread between vacancy and availability is extreme: Sorrento Mesa office vacancy is 14 percent, but availability is 26 percent; Carlsbad flex space is 19 percent, but availability is 24 percent; I-15 corridor office is 13 percent, but availability is 17 percent; I-15 corridor flex space is 21 percent, but availability is 27 percent. Another 5.2 million square feet are under construction in San Diego County — a figure not captured in vacancy or availability rates. That all paints a pretty scary picture for landlords in 2007.

**Time on the market is critical in residential real estate, but why is this the first time a commercial real estate professional has mentioned it?**

Time on the market is the commercial real estate industry's dirty little secret. The real estate industry does not want tenants to know how long space has been on the market. The time during which landlords are sitting with space will determine the best strategy for negotiations. Most CEOs are stunned by the amount of time landlords have been sitting on vacant office space.

The reason space has sat is that there has been virtually no net absorption for more than a year. Net absorption is the net result of space being leased versus space being vacated. Local companies are growing marginally, but the mortgage industry is dumping space county wide, as are big corporations such as Merck, Pfizer, Ericsson, Intel, Nokia, HP (formerly Peregrine Systems) and Avent (formerly Memec).

The market has been running in place for a year, and it's in long-term equilibrium. Although landlords have raised asking rental rates, there is no basis for inflation in rents.

**What kinds of opportunities does this equilibrium offer a CEO?**

The cost of space is a company's second-largest fixed cost. With this excessive time on the market and the overhang of sublease space, CEOs should consider adjacent submarkets that have greater availability and seek sublease opportunities that can be had for 20 percent to 30 percent below market. These conditions will favorably affect the ability to negotiate lower cost lease renewals into 2007 and 2008.

**What is the best strategy to optimize a lease expiration or expansion in 2007?**

Engage professional representation to position your company with the landlord and shop the market to fully develop leverage and alternatives.

The most disastrous approach is to call the existing landlord, or his broker, to renew the lease. The landlord now knows you want to renew your lease, and because there is no representation involved, the landlord knows the tenant has no information about market conditions and no alternatives on the table for consideration.

Landlords are in business to create return for their shareholders, and renewals directly with tenants have the highest ROI for landlords. The savings of 12 to 18 months of vacancy, $15 to $20 per square foot in tenant improvements, and the credit risk of finding a new tenant all become financial windfalls for the landlord in a direct renewal. Our objective is to obtain those savings for our client.

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