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Conventional wisdom has 'left the building' in downtown office market

By JASON HUGHES
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An article in this month's San Diego Metropolitan aptly describes the conundrum that exists in today's San Diego office market where landlords who desperately need tenants for their Class A office buildings are instead driving them away with rent increases ranging from 40 to 100 percent. Hiking rents to chase away the very business you need to keep makes about as much sense as the Chargers moving to Imperial County to increase game attendance. Vacancy rates are hovering at 15 to 16 percent for downtown Class A office buildings - a range that should be somewhat disquieting to any thinking landlord.

Conventional wisdom holds that the way to decrease vacancies in a building is to increase tenants and that the way a landlord does that is to sharpen his pencil. The idea is to keep the tenants already in the building and, if necessary, pirate others away from the competition by offering lower leasing rates and better terms and conditions. You know, get a little competitive.

Of course, conventional wisdom "left the building" where landlords dwell, quite some time ago. For the past few years - even into the present-day real estate jitters - landlords have been paying absurd prices for office buildings. In effect, the buying binge in which landlords thought they could simply pass along their high purchase price and other associated costs to their customers - tenants - has backfired big time.

Instead of hanging around to pay for the landlords' poor business decisions via massive increases in their rents, a growing number of Class A office tenants are considering moving into Class B - less desirable but more affordable - office space. Whether they intended to do so or not, the landlords are running off the very resources they need make even a reasonable purchase price for their buildings pencil.

The differences in rental rates between Class A and B buildings are not insignificant. Class A structures are averaging about $2.95 per square foot - with some landlords asking as much as $4.10 per square foot - an unprecedented and absurd level under any economic condition in San Diego's community of small- and medium-size businesses. Conversely, Class B buildings, where vacancy rates are 30 percent lower, are averaging $2.40.

A 55-cent difference for the average 3,500-square-foot user translates to just under $2,000 a month. Any reduction or increase impacts the bottom line of that small business.

Class A landlords not only are competing among themselves and facing owners of buildings of lesser quality and amenities, they are going to continue to compete on an even larger scale with their own tenants who are facing hard times and need to sublease their space. And, of course, those persistent basic fundamentals that drive any office market are still in play. Supply and demand comes immediately to mind. Ability of tenants to pay isn't that far behind.

Where on earth do landlords think they'll find new tenants to replace those who are fleeing the titanic rent hikes? In past columns, I've discussed the lack of important factors that tend to constrain an office leasing market, such as the lack of broad-based job growth, new company formations and corporate migration. The number of companies being formed or expanded here has been anything but impressive. Those that have formed businesses or expanded have a very limited tolerance for paying higher rental rates to cover sales prices abuses suffered by their landlords.

That our downtown's finest and most prestigious glass-and-steel edifices are being abandoned is certainly not a positive sign of upward mobility on the part of the community of tenants. It's not good community image building on the part of firms that once boasted of their prestigious office locations to now have to work in lesser digs.

There are other factors in play that add to the tenants' costly woes that Class A landlords are apparently choosing not to think about. For the past couple of years, more tenants have moved out of downtown office buildings than the previous ten years combined. The villain for much of the tenant exodus to date has been the critical lack of parking and high costs of what there is of it. Add to that the dilemma of massive rental rate hikes and we'll have an exodus of unparalleled proportions in our Class A market.

A goodly number of landlord brokers claim such concerns are unfounded, pointing to downtown San Diego's "curb appeal" and the fact that leasing rates elsewhere aren't all that less expensive. What they fail to take into account is the option for downtown tenants to opt for location, location, and a cheaper office building downtown.

There was a time we were worried about the lack of new shiny new office space coming on line to serve what we hoped would be a growing downtown office market made up of tenants destined to thrive. Maybe we should now be concerned about whether there's enough older and more common space to accommodate tenants determined to survive.

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