

A real look at trends in San Diego's office market

By JASON HUGHES

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It's a good time for tenants to be shopping for office space throughout the San Diego region's suburban locales, thanks to an office market that is "in equilibrium" and even quite favorable in terms of growing vacancies in some submarkets.

That piece of news, of course, is not what landlords and their broker skills are telling the tenants they strap into the back seats of their black Hummers to convoy them to their respective "once-in-a-lifetime" office space "opportunities."

But, it's fact nonetheless. Last week, we gave our tenant clients our quarterly market outlook in which we provided a perspective on where the market is trending, along with a supporting analysis. Rather than rely solely on other data that tend to under-represent all available space while reporting the artificially inflated rents landlords are trying to get to cover the inflated prices they paid for their buildings, we expand that information to provide a more comprehensive analysis of the condition of the office market.

Let me say before we continue, the companies providing incomplete or inaccurate data do not do so deliberately; they work with the data they get. Our company, as a way of protecting our clients' privacy, does not report to these outside agencies how much office space our clients lease or how much they are paying for it. We, alone, do enough business for that to have a real impact on the total accuracy of any market report in the region. And, I wouldn't be surprised if there were other brokers who likewise protected their clients' privacy. I can't name one off the top of my head, however.

Back to our analysis. Most shocking is the fact that the aggregate amount of available sublease space in the seven suburban markets has been trending upward for six-consecutive quarters -- having reached 4.87 million square feet. This is the largest sublease inventory in the past three years. What it shows is the impact of large corporate consolidations as well as ongoing merger and acquisition activity.

Mortgage and real estate brokerage firms are being hit hard by a cooler market and represent one of the biggest industry segments dumping office space onto the sublease market.

Sublease space is in demand big time. Roughly 15 percent of our client tenants are actively pursuing subleased space which can be had for somewhere between 20 and 25 percent below market rates. The wide availability of sublease bargains alone will keep a lid on rental rates well into next year.

Time on the market also is a factor that always causes considerable pain to our landlord friends. There is some reduction in how long the average space has been listed for lease or sublease, most notably in the University Towne Centre, where that average time span has decreased from 24 to 11 months. However, that tends to be an anomaly. The Interstate 15 corridor is the most volatile suburban market in terms of average time on market, now more than 31 months.

The overall availability rates have been relatively flat for this past year, symptomatic of the San Diego region's "zero net absorption market." This is a condition in which the amount of office space leased is directly offset by the amount of space vacated. For every company that grows, it seems there is another company that puts its space on the market for sublease -- or another newly constructed building that comes onto the market.

The Carlsbad submarket is expected to spike by the end of this year, reflecting the completion of several buildings now in advanced stages of construction. This market has already had growth of 2 percent or 3 percent per quarter in available space and so the new inventory coming online in the coming months, exacerbates the lack of net growth in demand Carlsbad has experienced in the past year-and-a-half.

Truth be told, there will be no dramatic growth in jobs and the employment sectors that will help absorb this office space for at least the balance of this year and next. We are not seeing evidence of big new companies coming into the region, neither will there be enough new company formations to make a significant dent in the vacant or available office space inventory. Zero net absorption is here to stay for a considerable while.

Likewise, there is no basis for hefty increases in rental rates, despite the desperate attempts on the part of

landlords to pass along the absurd prices they paid for their office buildings to their existing and new tenants. During the past few years, institutional investors have continually bid up the price of commercial office buildings in the San Diego region without any regard to what the viability of rental rates might be in the market. This "pass-along" trick doesn't work though; rents do not follow prices as landlords and their brokers have found out.

Tenants need to discover that as well.

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