

IRVING HUGHES

Life is a lease. Negotiate well.

Recent articles in *The Wall Street Journal* and *The Union Tribune* report rising vacancy rates and falling rents due to the soft commercial real estate markets, but the local and national press are documenting history and not news, as Irving Hughes has been reporting this trend for over two years. With our 20-year operating history in San Diego, and our representation of over 1,000 San Diego companies as we advise corporate tenants on their staffing plans and space projections in all economic conditions, our reporting has proved to be at the leading edge of economic and commercial real estate trends for several years running. We are pleased in this quarterly update to bring real news that the worst of San Diego's economic decline is behind us.

Few clients are contemplating layoffs, and most San Diego companies seem to have found a new equilibrium. While companies are smaller in size on average, Irving Hughes has lost very few client companies due to business failure over the last 18 months. Exceptions are in the real estate industry, including architecture and construction materials companies. The other exception is in the biotech industry, with more challenging news to come in the next year as the capital markets continue to be hard on the biotech sector. The San Diego economy has found the bottom, and there are additional signs of hope.

While there is no immediate expectation of a full-blown recovery, companies in certain technology, medical device and business service niches are slowly growing and creating new jobs. With consent of the following Irving Hughes clients are these examples: Eventful moving from 6,000 sf to 9,000 sf; Covario moving from 8,000 sf to 13,000 sf; Provide Commerce (the largest office lease YTD in the County) which moved last month from 90,000 sf to 154,000 sf; Volcano Corporation contemplating expansion from their current 20,000 sf up to 30,000 sf; Target Safety moving from 5,000 sf to 10,000 sf; ID Analytics contemplating moving from 27,000 sf to 37,000 sf; MIR3 expanding by 7,000 sf in the same location; Jitterbug, which recently opened a 23,000 sf call center in Carlsbad, now expanding by 11,000 sf; Chassis Plans, moving from 10,000 sf to 23,000 sf; Fate Therapeutics expanding their wet lab and office facilities from 6,000 sf to 24,000 sf; and Competitor Group which is expanding from 45,000 sf to 58,000 sf.

Even in light of these expansions, many San Diego companies are still saddled with too much space. Companies have been downsizing business activities and headcount for the last two years, resulting in more space availability across all submarkets and product types. See the market statistics at [IH Suburban Market Dashboard Q3 2009.pdf](#). This trend of rising availability continued last quarter and we expect it to continue throughout 2010 as companies with excess space move to smaller quarters, or downsize in place. The Irving Hughes team meets with an average of 30-40 San Diego companies every week, and there continues to be facility overhang in many companies that will need to be shed in the next 18 months. This situation has been referred to as "shadow vacancy" as it reflects space that is effectively vacant, but that is not marketable for sublease due to security, fire exiting or demising costs. Shadow vacancy will account for an increase of two percentage points of availability in some submarkets by the end of 2010. In addition, there is now 7.1M square feet of sublease space on the market that tenants are actively trying to dump, which continues to create a substantial drag on the market. Earlier this year, there was a spread between sublease pricing and "direct" space asking rents from landlords. Many landlords in UTC, Del Mar Heights, Carlsbad and Sorrento Mesa have lowered pricing to compete with the subleases, so it's now a battle between landlords and sublessors to secure leases or subleases from the very limited number of companies that are in the market for new space.

So will the landlords really default on their loans and lose their buildings as a result of this commercial real estate recession? Generally speaking, most of the larger landlords will not. While there will be a few buildings and projects in every submarket affected, we don't expect to see the widespread foreclosures of the early '90's when all but one downtown high rise was foreclosed on, and every high rise in UTC went into bankruptcy. Landlords like TIAA CREF have written down their Southern California portfolio by 44%, they have little debt, and have discounted rents at their properties. Arden Realty, with no debt on their buildings, has extended their assumptions about their hold-time before they can sell buildings at a profit, and they can now be more competitive over 2-5 year leases. Kilroy Realty, which owns approximately 7.5M square feet in San Diego, is financially strong and pricing deals at 25% less than just two years ago. Prudential, with properties around the region, is buying down their debt in order to maintain compliance with their loan covenants and is negotiating leases at well-off proforma. The Irvine Company, even with high debt levels on a few assets, has tremendous staying power with over 37M square feet owned in California to leverage off of, most of which is debt free—they too are cutting rents for our clients at 30% off what we were able to negotiate two years ago. The leases we are negotiating for clients today are the lowest that we have been able to deliver for clients in the last 13-14 years, and are very reflective of the bottom of the leasing market.

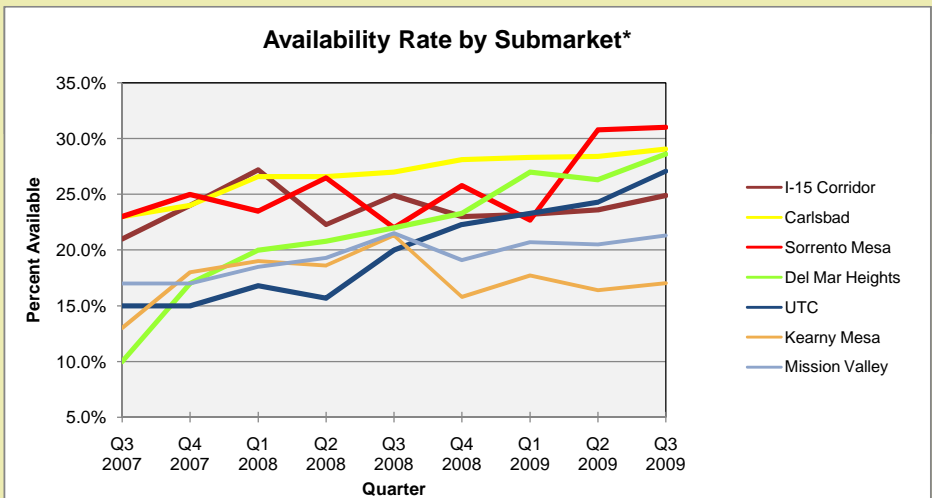
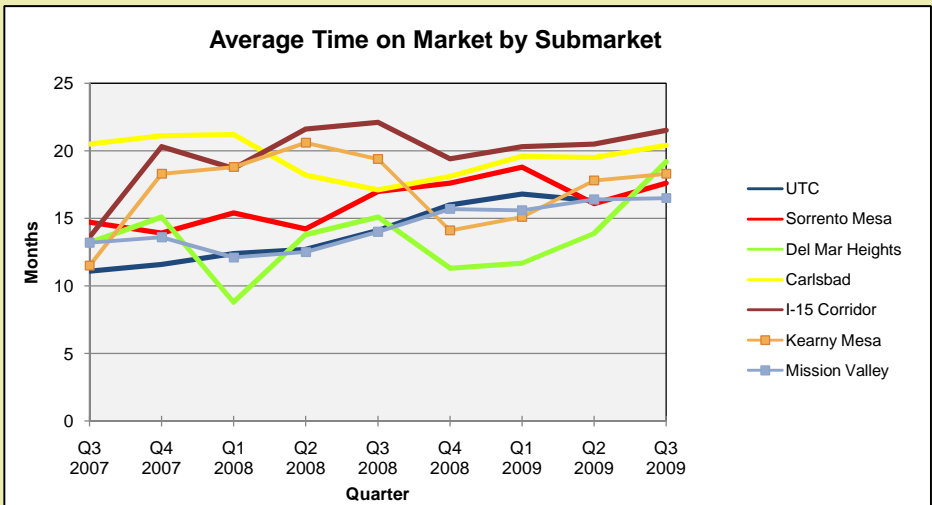
Now that we are finding the bottom of San Diego's economic recession, the commercial real estate sector is lagging behind the general economy and should hit bottom by the end of 2010. The question isn't only how low it will go, but also how long it will last. We expect an extended economic trough for the next two years thereafter, and any commercial real estate rebound will be delayed even further as companies slowly respond to an economic recovery, and begin investing in headcount growth and business activities.

Irving Hughes Market Trends

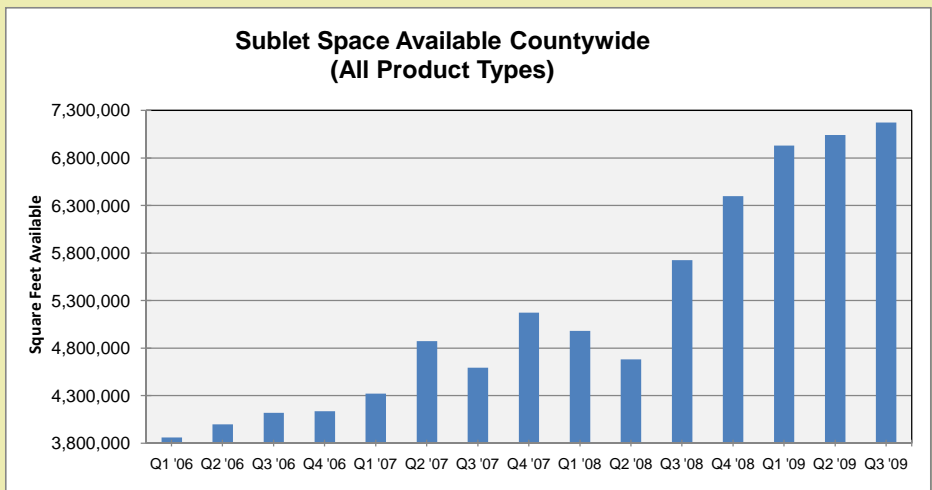
San Diego Suburban Office Markets

3rd Quarter 2009

Source: CoStar Group



* Unlike the traditional "sell-side" commercial brokerage houses which measure "vacancy" rates in the narrowest possible terms, Irving Hughes measures "Availability Rates" which include all existing direct and sublet space listed as available for lease.



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Irving Hughes Market Dashboard

San Diego Suburban Office Availability Report

3rd Quarter 2009

Source: Costar Group

	Sublet Available	Direct Available	Total Available	Leased	Existing RBA
<i>I-15 Corridor</i>	229,818 2.1%	2,453,170 22.8%	2,682,988 24.9%	8,679,215 80.5%	10,776,444
<i>Carlsbad</i>	307,236 5.0%	1,484,528 24.1%	1,791,764 29.1%	4,852,153 78.7%	6,165,671
<i>Sorrento Mesa</i>	529,696 7.1%	1,773,407 23.9%	2,303,103 31.0%	6,019,752 81.1%	7,421,426
<i>Del Mar Heights</i>	294,224 6.7%	954,335 21.9%	1,248,559 28.6%	3,545,514 81.2%	4,364,719
<i>UTC</i>	320,260 4.8%	1,474,947 22.3%	1,795,207 27.1%	5,500,598 83.0%	6,627,704
<i>Kearny Mesa</i>	186,308 2.1%	1,344,085 14.9%	1,530,393 17.0%	7,921,500 88.0%	8,998,655
<i>Mission Valley</i>	109,184 1.6%	1,338,630 19.7%	1,447,814 21.3%	5,753,400 84.6%	6,801,081

