

Symptoms emerging for a full-blown recession

By **JASON HUGHES**

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Noted fund manager Peter Lynch once observed in his "One Up On Wall Street" that he obtained his best information by simply looking at real life situations around him, rather than depending on formal economic analyses and market gurus. If real life in much of San Diego is any reliable economic indicator, then it's increasingly clear that our local economy is in the early stages of a full-blown recession.

One primary indicator is real estate. Never in my 20 years in commercial real estate have I seen as much sublease space on the market as the present time. That includes the S&L crisis of 1989-91 and the more recent dot com crash of 2000-01 when they gave rats ticker-tape parades for being the only occupants in the empty hallways of many San Diego office buildings. Business owners and other managers are slamming the door shut on office space costs in increasing numbers. Occupancy patterns are a major predictor of our region's economic health. It's the canary in the coalmine that, in this case, suddenly keels over.

But wait, there's more to the perfect storm that's building over our economy's horizon. Office buildings have been selling for all-time high prices both in price-per-square-foot and sales volume. The crazy debt market of recent years had made just about anything conceivable pencil, including buying office buildings for less than a 5 percent yield on the following year's projected - but unattainable - rental rates. In other words, they've been pouring hundreds of millions of dollars into office buildings on the off chance of obtaining a lousy return on something that will never materialize.

Take a look at the broader real estate picture. The recent and continuing sub-prime loan debacle has now produced tougher borrowing standards, resulting in less debt issued. All the homeowners who used their personal residences as ATMs to turn equity into cash in recent years are now finding that they no longer have any equity. A growing number of them are discovering that they owe more on their homes than what they're worth. Many of those are having more difficulty making their monthly mortgage payments due to increasing interest rates that are kicking in on their variable loans. That results in having less disposable income for purchasing other goods and services. The "trickle-down" effect suddenly becomes a raging torrent in terms of its impact on other segments in our economy.

The net impact of this is the unraveling of the commercial real estate sector with REITs and other real estate investors getting shellacked. Consequently, there is less money to spend and invest which reduces corporate profits. That reduces company stock prices, which then leaves less net worth for those who thought they had a few bucks to spend. The sound you hear in the background is the economy's toilet flushing.

Now to the office sublease situation and the impacts it both creates and responds to regarding the growing downturn in our economy. Office leases are contractual obligations for an amount of space under specific terms and conditions for a designated period of time. Just as with automobile leases, it is possible for the lessee to assign the lease to another party. There are consequences, though, and so it's important to work with a professional in such endeavors.

There are growing numbers of office suites emptying out as nervous businesses cut jobs and slash expenses wherever they can. Reducing jobs and occupancy costs are always the first priorities in such situations. And, it's not only the big guys - Countrywide, Accredited Home Loans, et al - who are slashing their costs to try to survive; the effect drops down to dozens of companies. Growing numbers of escrow, title, brokerages, construction contractors, and other lenders have cut back or in some cases, have gone out of business in the belt tightening exercise that inevitably precedes a recession. The list will probably expand to include developers, insurance firms and even some law firms in the near-term.

So, what does this mean to office tenants who are relatively immune to the real estate calamities? For one thing, we're coming back to the good old days of real bargains in office space where landlords are forced to bargain in good faith with tenant customers. Even the most sophisticated and haughtiest of landlords have realized that the tide has turned and that in order to lease up their space, they need to sharpen their pencils when it comes to offering free rent and more decent tenant improvement allowances. They no longer are just competing with other landlords; they're also competing with their own tenants who are trying to sublease space. It's not the best of news for those tenants wanting to sublease their space, but it's good tidings for the consumer - the tenant looking for a bargain in office space.

Too bad it takes so much corporate bloodshed to level the playing field.

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