SANDIEGOSOURCE
The Daily Transcript

Thursday, January 03, 2008 editor@sddt.com http://www.sddt.com Source Code: 20080103tdh

Tenants may hold the upper hand in San Diego's office market this year

By THOR KAMBAN BIBERMAN, The Daily Transcript
Thursday, January 3, 2008

There could be a tenants' market for office space in the next three years, but industrial and retail space is expected to continue to be difficult to find.

Jason Hughes, principal of the **Irving Hughes** tenant representation commercial brokerage firm, predicts it will be at least 18 months before there is a landlords' market in downtown San Diego in particular.

"Most tenants are in contraction mode," he said.

Hughes said landlords in downtown San Diego and in other submarkets in the county are having to provide generous tenant improvement allowances, and some amount of free rent that could amount to 12 months on a seven- to-10-year lease transaction. "The county, especially downtown (San Diego), is going to be sluggish for a while," Hughes continued.

The tenant broker also warned that when interest rates reset, some commercial building owners holding interest-only and variable rate loans could find themselves in a comparable situation as some residential owners -- unable to make their significantly higher payments.

"Buildings could go into foreclosure. I don't see anything dire on the horizon, but the potential is there," Hughes said.

Hughes said "quality" landlords with premium properties will always do well. "There's always going to be a market for premium quality. It's the borderline, or functionally obsolete properties where you're going to have a problem."

Kraig Kristofferson, a **CB Richard Ellis** (NYSE: CBG) senior vice president, countered that it's not as strong a tenant's market as Hughes and some press reports have suggested in downtown San Diego.

"We are not seeing extreme concessions. We are seeing more money for tenant improvements, and some free rent is being given, but not a lot," Kristofferson said.

CB Richard Ellis has yet to compile its year-end office vacancy figures, but a third quarter report showed they were hovering around 12.3 percent in downtown (Hughes says this figure is closer to 16 percent) and 12 percent countywide.

The countywide office vacancy had been placed at about 9.7 percent in the third quarter of 2006, but that was before the addition of about 3 million square feet of space.

"There's not a lot of sublease space downtown -- about 83,000 square feet -- and none of it is in big blocks," Kristofferson said.

Hughes argues if all the available space in downtown (direct and sublet) is taken together, it amounts to 1.8 million square feet.

Scott Kincaid of CB Richard Ellis said while Sorrento Mesa's published vacancy was just 7.3 percent as of the end of the third quarter, the submarket had 25.8 percent available space.

"That's a more meaningful figure," he said.

Kincaid said he was floored to discover that Qualcomm occupies some 4 million square feet in the Sorrento Mesa submarket: 1.1 million leased and 2.9 million owned.

"That number is staggering," Kincaid said.

Industrial vacancies are in the single digits in most markets, but a **Burnham Real Estate Services** third-quarter industrial report pegged Otay Mesa's industrial vacancy at 17.3 percent -- despite a shortage of readily buildable parcels.

Tully, who said the 14 million-square-foot Otay Mesa industrial market is running at around 20 percent vacancy, said that level was pushed up by the addition of about 1.5 million square feet late in 2007.

Tully said the bad news is the economy has slowed down. The good news is with very few finished lots, "there will be plenty of opportunity to catch up."

While retail vacancies in this region have tended to be close to 3 or 4 percent depending on the survey, they have climbed a little bit in a dubious economy. Still, retail remains one of the most sought after asset classes in one of the strongest markets in the country.

With the explosion of the Temecula and Murrieta areas in the 1990s as families fled San Diego County in search of more affordable housing, developers scrambled to build millions of square feet of retail space on and around the Winchester Road Corridor to meet the demand.

Doug Hogan of Burnham Real Estate said the retail market has been very good for newer projects, but those getting stale haven't fared nearly as well.

"The secondary centers are feeling the crunch. There has been a slowdown in capital markets and the slowdown in housing is going to be having an effect," Hogan said. "There are still real good strong developers out there, but there are others who may be overextended."

Hogan said the retail market should be sluggish for about the next nine to 18 months.

Still, Hogan said although there may be some tenants in San Diego and Southwest Riverside counties who might hope for more favorable lease terms, there is no shortage of demand.

"I have back-up tenants," he said. "That gives you an idea."