

Vacant, available space will dominate local office market in 2008

By **JASON HUGHES**

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This isn't the first time I've had occasion to comment on the softening taking place in the region's commercial real estate market. But, it's somewhat akin to the old advertising adage that one needs to say something several times before it begins to take root in the minds of one's audience.

I've taken no pleasure in reporting bad news about the economy; certainly not about the industry where I've made a living for the past 20-plus years. But I find it even less appealing to stand by and keep silent on matters that are of critical importance to the state of the real estate market. At times I've felt like a prophet shouting against the howling rhetoric of brokers and others who have tried to spin the growing glut of office space in a totally different - and inaccurate -- context.

For example, one brokerage suggested last summer that the "surge in office space development was expected to be easily absorbed." In late September, another pundit predicted that "while some may worry about ... the collapse of the subprime market and the ensuing layoffs ... any losses would be rendered insignificant by employment gains in other sectors of the economy." I remember wondering to myself when I read that: "What other sectors?"

But the corker was the published prognostication by a local real estate brokerage in early November that predicted "... only slight increases in vacancy rates were expected for the office and industrial sectors during 2008." To be fair, they didn't specify which planet they were referencing.

Finally, it appears the spin casters are coming out of denial. The grinding news about the state of economy in recent weeks is bringing about a more realistic assessment of its impacts on commercial real estate, in particular, the office market.

In fact, a growing number of observers and real estate practitioners are grudgingly acknowledging what this column began proclaiming as far back as last April: there's a growing abundance of both vacant and available office space throughout the San Diego County region and the impacts of an increased supply are favorable to office tenants who are in position to lease space.

The cold hard facts tell the story. The overall vacancy rate in the region for the fourth quarter was 14 percent -- up from 10.7 percent in January of last year. There was a 20 percent vacancy rate in Carlsbad and Rancho Bernardo submarkets even before the beginning of a new year. That's a lot of empty space.

The availability rate for office space that is now occupied but soon to be vacated is as high as 25 percent in Sorrento Mesa and Carlsbad and spiking upward in nearly every other sub market, except for the University Towne Center which has problems enough of its own with landlords having to compete with existing tenants. In that area, there is as much sublease space on the market as there is space being offered directly by landlords. In fact, 6 percent of the total space in that area is available for sublease. So much for the aforementioned prediction of employment gains in other sectors if employers are trying to shed that much space formerly occupied by workers.

Most startling is the fact that the aggregate sublease space throughout the county now tops five million square feet -- a level reminiscent of the post dotcom bust seven years ago. The increasing overhang of sublease space should top out this year, but this glut of space will result in landlords losing more tenants than they retain by year's end.

Much of this increase in available and subleased space is due to the slaughtering cutbacks on the part of title, escrow, mortgage, and homebuilder tenants who are either closing up shop or cutting their operations back next to nothing for the long, cold economic winter.

This year, we are going to see considerably more concessions being made by landlords who will be struggling to recruit and retain tenants. Market forces are now dictating - not merely suggesting anymore - free rent, moving allowances, higher tenant improvement allowances and eventually, lower rental rates.

The downturn we're experiencing is showing no sign of abating anytime soon - certainly not for the balance of

this year. It will be well into next year before any relief is in sight and for some sub markets such as the I-15 corridor and Carlsbad, the office market downturn may continue for three to five years because of the extensive overbuilding in that area.

If there's any good news in all this, it would be for the healthy tenant who is either looking to relocate or renegotiate his or her existing space. It's as competitive a market as it's ever been and tenants are in the driver's seat, behind the steering wheel, when it comes to negotiating a fair and equitable lease.

Given the driving metaphor, negotiating with landlords is a long and winding course for tenants to traverse and I would be remiss if I didn't urge tenants to get driving directions from a professional.

Hughes is a principal with Irving Hughes, a tenant representation company. He can be reached at jason.hughes@sddt.com. Comments may be published as Letters to the Editor.