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Commercial real estate faces challenges in coming year

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While 2008 is expected to be a good one for commercial real estate in San Diego County, overbuilding in some areas and turmoil in the credit markets is expected to put a damper on enthusiasm.

"All things considered, it was a good year", said Eric Better, vice president of **George Smith Partners, Inc.** "Multifamily and retail properties were the most popular this year, followed by office and land. We actually saw an increase in industrial and residential transactions in 2007.

Office

Marten Barry, Jr., **NAI San Diego** president, said while the robust investment climate of the past two years is definitely cooling," San Diego's economic diversity, climate and coastal Southern California location should help minimize the impact of the current downturn.

Commercial office markets worldwide enjoyed a strong year in 2007 with slightly declining vacancy rates, rising rents and record sale prices, according to NAI's 22nd annual Global Market Report.

However, the 2008 outlook is clouded by uncertainty following the mid-year emergence of sub-prime debt problems, volatile credit markets and record high oil prices.

Closer to home, a CDC Commercial report says the countywide office vacancy is running at about 12 percent. With millions of square feet of office space under construction and more in the pipeline, vacancy rates are destined to climb.

This is particularly true in submarkets such as Carlsbad and Rancho Bernardo, which already have vacancy, levels at 20 percent if not higher.

Both the NAI and the CDC reports say while office building owners shouldn't worry too much, they will have to work harder to keep a steady cash flow.

"Damn the torpedoes -- the economic minefield won't be enough to stop office rent growth. However, rent growth and occupancy will be challenging for 2008.

Overall, the San Diego office market remains fundamentally sound," CDC wrote.

"However, a short-term spike in vacancy and length of time on market will plague 2008, causing landlords to be more flexible and aggressive with rent, terms and concessions until local employment growth and strong economic prosperity return to local markets," CDC continued, adding that it will probably be upward of 18 months before markets stabilize.

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"With a countywide average absorption of 1 million square feet a year (five-year historical average) and nearly 3 million under construction, you can expect the office market to remain competitive in its search for the office tenants," CDC wrote.

The slowdown in the office market here appears to be universal, but is not expected to be slow forever.

"Fears of a slowing U.S. economy and the credit crunch are clearly having an effect on investment real estate markets, even though commercial real estate fundamentals remain strong," said Jeffrey M. Finn, NAI global president and chief executive officer. "However, we believe the slowdown in activity is only temporary as the credit markets sort themselves out and a new pricing equilibrium is established. The U.S. economy remains fundamentally strong and supply is tight, especially in resurgent downtown areas. The U.S. story is counterbalanced by a dynamic global landscape with vast new markets continuing to grow at a rapid pace."

"Some pundits are predicting an imminent recession in the United States and eventually they will be correct as they have been predicting a recession for the past five years," added NAI Global Chief Economist Dr. Peter Linneman, professor of real estate at the Wharton School, University of Pennsylvania, and principal of **Linneman Associates.** "The U.S. economy is too strong, and most companies and consumers are simply too well capitalized for a recession to be triggered by the current capital markets disarray."

Finn further noted opportunities will emerge from the current volatility: "The credit crunch is leaving many domestic investors on the sidelines for the time being, but a weak U.S. dollar and the relative returns to other global real estate markets make U.S. real estate quite attractive to offshore investors."

Downtown San Diego's office vacancy was running at about 13.4 percent with an availability rate of 18.9 percent as of the end of the fourth quarter 2006.

The Class A space downtown is plus or minus 10 percent depending on the survey.

In 2007, U.S. markets reported generally tightening vacancies and modest increases in rents. With any lingering remnants from the dot-com bust erased in 2006, the supply side is remarkably stable, as evidenced by the modest drop in the vacancy rate for Downtown Class A office space from 9.85 percent in 2006 to 9.55 percent in 2007, NAI concluded.

Retail

"County wide retail vacancy was just under 3 percent and this is after absorbing almost a million square feet of new construction," CDC writes. " However, retail headwinds have stiffened."

CDC said condo conversions, the credit squeeze and high-energy prices have all put the squeeze on the consumer.

Retail sales growth is definitely slowing but it hasn't turned negative. Retailer bankruptcies have only hit the home furnishing chains so far. Even with a decline in consumer confidence, retail vacancy rates should remain fairly stable. Less new inventory being built will also help improve fundamentals and stability in 2008," CDC concludes.

Retail vacancy rates declined modestly in all categories and are at their lowest levels in over five years. The most significant growth in rental rates occurred in regional malls, where the national average rose from $44.97 in 2006 to $46.26 in 2007. The rental rate for downtown retail climbed from $47.70 in 2006 to $48.09 in 2007, NAI reports.

Industrial

CDC projects industrial absorption will drop from 4 million square feet to about 300,000 square feet this year. Vacancy in the North County is running about 8.5 percent.

"It would appear that we will engineer a soft landing with new under construction projects diminishing just as vacancy is increasing and demand decreasing," CDC wrote. The average price per square foot of industrial buildings sold is running just below $170 per-square-foot and is expected to remain flat for 2008.

"Of great importance is the expensive and short supply of available land. With $20 to $30 per-square-foot plus land values, "classic industrial" is not viable," CDC added.

"Instead we are now faced with the development of R & D (research & development) or 'flex-tech.' These buildings have more office space and parking, and are typically occupied by higher rent paying aerospace, technology and biotech companies, CDC continued.

CDC said the demand for industrial space should remain steady with 2007 levels (but behind '04, '05 and '06 levels).

"Landlords will step up concessions, free rent and tenant improvements in an effort to maintain occupancy," CDC concluded.