Signs of a Healing Market

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Looking back, 2010 turned out to be the commercial real estate year that we forecasted it would be — it hit bottom hard and has stayed there. It remains a great time to be a tenant, and in the approximately 180 leases that The Irving Hughes Group transacted for over the last three quarters, representing almost 3 million square feet across the region, the rent and concession outcomes have been excellent and consistent. This year promises to be a year of bumping along that bottom, with the earliest signs of some marginal healing in certain submarkets.

First Sign of a Healing Market: Less Sublease Space

The aggregate amount of combined office, flex and industrial sublease space on the market continues to fall off just as fast as it flooded the market. In the second quarter of 2008, sublease space was just over 4 million square feet. It peaked at 5.8 million throughout the last half of 2009 and into the first quarter of 2010, ending 2010 back down at just under 4.4 million square feet. Few San Diego companies are putting new sublease space on the market, which is a sign of business stability and overall economic health. At the same time, the subleases on the market are very desirable to tenants still looking for low-cost rent values, and some of the sublease inventory is expiring such that the sublease space converts to "direct" space from landlords. Either way, with less sublease space on the market, landlords will begin competing more often against other building owners for new tenants, versus losing tenants to cheap subleases.

Second Sign of a Healing Market: Less Total Space

To provide some historical perspective, in 2005 there was 27 million square feet of combined office, flex/lab and industrial space on the market for lease or sublease in San Diego County. In 2006/2007, a net 7 million square feet of combined office, flex and industrial inventory came on the market, due mostly to new construction and speculative development. In 2008/2009, another 15 million net square feet of unanticipated inventory came on the market due to the economic shock we all lived through. At the depths of the recession in 2009 and into 2010, approximately 50 million square feet of total combined office, flex and industrial space was on the market in San Diego County. For the first time in over five years, total availability fell in the fourth quarter of 2010 to 48.3 million square feet. This is a trend that will continue, but in a very gradual and bumpy downward pattern.

It is hard to imagine the market returning to 2005 levels anytime in the near future, but that is what it will take to return to a "landlords' market." While everyone seems bullish on a slow economic recovery beginning this year, it will take massive job creation to fill up available office space. Tougher yet, it will take a ramping back up of the construction materials supply chain, and manufacturing raw materials/finished goods inventories, to fill up available industrial space. This recession's damage to the local commercial real estate market is unprecedented in the last 17 years. It's going to be a long and painful road for landlords to recover their losses, but the healing of the commercial landlord community will be driven by a healing of the San Diego's non-real estate industry sectors.

Third Sign of a Healing Market: Office Availability Rates Trending Down

This decrease in sublease space and overall square footage is beginning to translate through to declining availability rates across most major office submarkets: the I-15 corridor office market started the year at 26 percent and ended at 22 percent; Del Mar Heights started at 23.4 percent and ended at 21.4 percent; and Mission Valley started at 21.5 percent and ended at 19.2 percent. Sorrento Mesa, which started the year at 29 percent, ended at 20.8 percent — the lowest office availability rate Sorrento Mesa has had in over five years. UTC and

Carlsbad office space stayed effectively flat, and Downtown has entirely stalled with more companies still leaving Downtown and none moving in. Notwithstanding, availability rates at 20 percent or higher are symptomatic of a very tenant-favorable market, so we don't expect rental rates and concession packages to change materially in the near term. 2011 will be a great year for tenants in all industries and all submarkets to structure excellent renewals and expansions, or to move into better quality buildings at lower costs.

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