



# No Immunity This Time Around

By Maria Wood

**THANKS TO ITS GEOGRAPHY,** sunny climate, diverse tenant base and generally pro-business atmosphere, Southern California's commercial real estate market has been somewhat insulated from the current national economic downturn. What's more, with so many submarkets within its borders performing at varying degrees of vitality, the region almost acts like a diversified portfolio of properties, where cash-cow assets pick up the slack for the laggards.

But to say the region is completely immune would be incorrect. Even while expressing their usual optimism, area insiders do concede that transaction and leasing velocity have slowed, rent growth is stagnant in some submarkets and yes, Orange County office owners have taken the brunt of the fallout from the subprime mortgage collapse.

"The beauty of Southern California is that it is so diversified that trouble in one business group is not going to create a meltdown here," says Bob Safai, founder and president of Madison Partners, a brokerage

firm based in Los Angeles. "Velocity has slowed down, but hasn't come to a halt and pricing hasn't adjusted. The leasing market is still rather robust and a lot of people are renewing their spaces, worried about rates going up. The lack of development and available footage doesn't make it a tenants' market; it's still somewhat a landlord's market. But that shift could take place if the economy softens a little more."

Besides a varied business base from which to draw strength, Brandon Birtcher, president and CEO of Irvine-based Birtcher Development & Investments, maintains that the region has other distinct advantages. "Southern California has many different cultures," he says. "As a result, there is a broad set of services geared to those cultures and we have a very diverse labor pool. The climate continues to be a major lifestyle draw, and as long as we have that, we will continue to see migration into the market from other states and countries."

Even so, the region's office market

appears to be decelerating somewhat. The Los Angeles County office vacancy rate grew slightly in the fourth quarter, rising to 9.2% from 8.9%, according to CB Richard Ellis. However, the firm points out that this modest hike "does not reflect the increase of sublease availability seen from recent business contraction."

Further south, in San Diego, a spate of new construction deliveries combined with a dip in demand pushed office vacancies up 1.8 percentage points since midyear to 14% at the end of '07, reports CBRE.

Marcus & Millichap Real Estate Investment Services projects that the office sector in the Inland Empire counties of Riverside and San Bernardino will end this year with a 15.1% vacancy rate as completions total 1.5 million sf.

Though those two preceding vacancies are high, perhaps hardest hit in the region is Orange County, which had to contend not only with consolidation among its many residential mortgage firms, but a 4.4-million-sf

Southern California is a market of contrasts. The West Los Angeles submarket of Hollywood, where the Kodak Theatre (left), home of the Academy Awards, is located, is one of the strongest areas of the region, while Downtown San Diego's (right) office market may be overbuilt.



## THOUGH STILL FUNDAMENTALLY STRONG, THE REGION'S POSITIVE FORCES HAVE NOT FULLY PROTECTED IT FROM THE NATIONAL ECONOMIC SLUMP

gusher of new development during 2007, states Voit Commercial Brokerage in a Q4 report. That resulted in a 57% year-over-year jump, pushing the year-end rate to 12.4%.

Meanwhile, all major regions of Southern California sported single-digit industrial vacancy rates as of Q4, starting with a low of 1.6% in Los Angeles, according to Grubb & Ellis. Voit recorded a 4% rate in Orange County and 7.9% in the Inland Empire. San Diego's overhang of untenanted industrial space checked in at 7.2%, CBRE reports.

Michael Zugsmith, Los Angeles-based chairman of NAI Capital, cautions that a one-size-fits-all overview of the entire Southern California market is unrealistic and misleading. Not only do the various submarkets perform differently, but individual property sectors may be strong or weak depending upon the location.

"A good example would be Valencia in the Santa Clarita Valley," he says. "Retail

leasing there is hot, and smaller industrial units of 10,000 sf and below are both leasing and selling. But in the same Santa Clarita Valley, an area slightly north called Castaic is very soft. In Bakersfield, a small industrial unit tends not to move very well, but a mid-sized unit, say 20,000 sf to 30,000 sf, is a hot commodity. We are seeing situational weaknesses in certain sectors, but not weakness overall." In such an inconsistent market, brokers must focus on the areas that are showing vigor, Zugsmith states.

No one is denying that there have been some slight, but perceptible scratches in Southern California's armor, such as the drag that the subprime meltdown has created in Orange County. But even as brokers recognize problems in that sputtering market, they are nevertheless confident the area will eventually recover.

"There are pockets in Southern California where office has been overbuilt, such as in the Airport area of Orange County and maybe even Downtown San

Diego," Birtcher says. "When we look at the tenant base that was there, there was a disproportionate share of mortgage lenders and related service companies. So when the residential mortgage industry shut down, these companies were quickly impacted and hundreds of thousands of square feet has been vacated and brought to market. But we will burn through that space for all the right reasons."

Joseph Vargas, Cushman & Wakefield's executive managing director and area leader for Southern California, contends that media reports center too much on the fallout from the subprime crisis in Orange County rather than the stability of Southern California overall. "We have less than a 4% vacancy on a nearly two-billion-sf industrial base and we have a 10% vacancy or less throughout all of Southern California on office space," says the LA-based executive. "So that would suggest fundamentally a very strong market, or at least a sound one given the economic uncertainty.

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Orange County, where the Irvine Spectrum (left) resides, has borne the brunt of the collapse of the residential subprime mortgage sector, but is still fundamentally sound, say the experts. Meanwhile, Los Angeles (right) is an attractive place to live and work. (Photo courtesy of Los Angeles Convention & Visitors Bureau.)



**BOB SAFAI**  
MADISON PARTNERS

*"Southern California is so diversified that trouble in one business group is not going to create a meltdown."*

"In the real estate world, people are focusing on the problem areas and those that have a high vacancy due to conditions that no one expected to exist," Vargas continues. "We all knew there was going to be about four million sf of construction, but we didn't know the subprime business was going to melt down and add a significant amount of space to the market. As a result, we've gone from approximately a 7% vacancy at the beginning of 2007 to 17% in the Orange County airport area in early '08. That's significant, and the general public likes to focus on the pressure

points. But if you look outside the airport market, into central and western Orange County, there is still a sub-10% or 8% vacancy. It's still a strong market."

Seconding those sentiments is John Harty, senior vice president at Voit Commercial Brokerage in Irvine. "If you look at the impact of the subprime collapse, you would think that the office market is in horrible shape, but that is not the case. Activity levels, while I wouldn't call them fantastic by any means, are surprisingly good given the economy," he finds. "Orange County has a 100-million-sf office market. The subprime sector only accounted for about 5.5 million sf. It's not like there is one industry that dominates Orange County."

For the region as a whole, Birtcher ticks off a list of other business sectors that are making their presence felt, such as technology, biomed, biosciences, entertainment and aerospace. Due to the planned enlargement of the Port of Los Angeles and Long Beach, logistics firms are active, as are companies targeting the region's burgeoning

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NAI CAPITAL

*"We are seeing situational weaknesses in certain sectors, but not weakness overall."*

ethnic population. "The millions of new Asian and Hispanic members of our community need services, from legal advice to retail stores," he asserts.

But as consumers go shopping in Southern California malls, are investors perusing its commercial assets? According to the experts, they are window-shopping until the current credit crunch subsides.

In actual volume, Safai estimates that the investment sales market is off between 65% and 70% from last year. "It is not predicated on the quality of the assets. It's due to the reticence in the marketplace because of the uncertainty in the economy."

As an example, Safai talks about a current transaction he began working on in January, a disposition of an office building. He declines to give specifics, other than to say he represents the seller and that there are nine bidders eyeing the deal, which had originally been penciled in for a first-quarter close.



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**BRANDON BIRTCHER**  
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"A year ago, the deal would have gotten done in a timely fashion and for \$15 million to \$20 million more," he relates. "Now, it's dragging out longer and frankly, there isn't stability in the marketplace on the debt side as well as equity's desire to put money out. It is uncertain whether the deal is even going to happen."

The property trades that are happening, according to Safai, are smaller—\$25 million or less. "Regional banks and insurance companies are stepping up with 60% to 65% leverage," he explains. "Last year, you'd

have 75% to 80% leverage. There has been a complete about-face in the debt markets, which has led to an about-face on the acquisition side and cap rates are starting to move upward. A year ago, we were doing deals at four or five caps. Now you are looking at 5.5% to 6.5%. Last year, investors were okay with betting on the come, buying for the future, believing rents were going to continue to go up in a very supply constrained market. Today, they want cash-on-cash yields. That's a big change."

With so few significant transactions being done, it's hard to get a read on where the investment market is headed, Vargas says. "I wish I could tell you that cap rates are higher and terms are different, but I haven't seen many large deals close," he says. "It's a game of who's going to make the first move. Are the banks going to open up their purse strings? Are sellers going to become more realistic on their pricing and are buyers going to step up to it? Or are they just going to wait and see? We are not in a market that is going up or going down. It's flat and no

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*"We are not in a market that is going up or going down. It's flat and no one is willing to make a move."*

**JOSEPH VARGAS**  
CUSHMAN & WAKEFIELD

one is willing to make a move. It's a bad time for brokerage."

Voit's Harty describes the investment scene not only as slow, but almost illiquid. "Pricing has not adjusted to meet buyers' expectations and sellers aren't being forced to sell," he observes. "So you have a situation where the 'ask' has not adjusted to the new 'bid.' And the new bid is lower due to cap rates sneaking up a bit and debt and equity becoming more expensive."

A similar languid pace exists in the leasing market. If not forced to move, tenants are staying put. And with little new construction and vacancies in some submarkets starting to rise, firms are not under any pressure to seal a deal.

Nonetheless, Harty maintains there is still a steady amount of leasing activity. "With vacancies being up, there is no pressure on tenants that their preferred building is going to be leased from under them," he says. "That tends to get rid of some of the quick



Although the investment market has slowed, smaller deals are getting done. North County, a Coldwell Banker Commercial affiliate, recently brokered the sale of a 49,352-sf office property at 17171 E. Gale Ave. in the City of Industry for \$9.2 million.

deals you see in a tight market when you close in two weeks. But it's not categorically true that all deals are taking longer. Leases are getting signed just as quickly as they would have two years ago. Generally speaking, tenants tend to take their time a bit more these days. They've got more choices and less pressure."

Moreover, space users typically opt to re-up in their current digs when the economy is shaky. "Renewals are very indicative of the state of the market right now, because they are always perceived to be the least

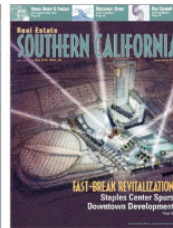
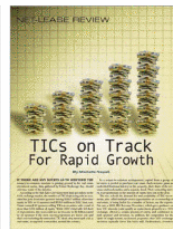
expensive option," Harty says.

Harty further states he is working on a half-dozen deals that represent either new requirements in the marketplace or expansions, a circumstance he views as surprising given the current economic slump. "We saw the mortgage companies shut their doors, but we didn't see the other firms out there going from 50,000 sf to 30,000 sf, which was prevalent during the dot-com bust in the early '90s," he says. "I think that bodes well for the marketplace and the speed at which it will recover."

Zugsmit of NAI Capital reports that even a seemingly bad market can produce a high level of activity. His firm has 16 branches scattered throughout Los Angeles, Orange, Riverside, San Bernardino, Ventura and Kern Counties. The company's gross commission revenues were up 26.2% year-to-date as of the end of February versus the same period in 2007, he says. "Our brokers are experiencing extremely full pipelines, with lots of pent-up demand from people who want to make sure that if they are going to buy or lease, they do so at the bottom of the market," he says. "Conversely, lessors or sellers want to make sure that they are not

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## Downtown LA Condo Re-Sales Take Downturn

IN RECENT YEARS, MANY OF Downtown Los Angeles' older office buildings have been converted to residential use, thus sweeping away obsolete and vacant properties and creating a hot new market. However, according to Condosource Inc., sales of existing Downtown condominiums and lofts have slowed and prices are down.

In the first two months of 2008, the total number of units sold amounted to nine, a 44% drop from the same period a year earlier when 16 were snatched up. Similarly, the median price per sf declined 12%, going from \$516 to \$453. Also down was the median sales price, which fell 18% to \$515,000 from \$629,500.

Troy Soumis, president of Condosource, a brokerage firm specializing in Downtown LA condos and lofts, terms the current re-sale market for those types of units as anemic. "Downtown LA has done a 180-degree turn from this time last year. We are now in a strong buyer's market," he says. "Until the current inventory of new units is sold, re-sale activity will remain weak."

at the bottom of the trough, so to speak. So while we have seen a high degree of uncertainty, we have also seen a lot of deals being made.”

Just as performance varies by submarket, so does rental rate movement. “If you look at the trailing 12 months, I’d say rents are down at least 10% effectively,” Harty says. “But there doesn’t seem to be a lot of downward pressure. In some places, it feels like we’ve gotten to the point where that is enough of an adjustment. Other markets are probably

going to see rental decreases, but the majority of them will likely be flat for the rest of the year.”

C&W’s Vargas concurs that the cost of space varies. “Posted lease rates are not going down,” he says. “In certain locations, you are going to see more concessions, whether it be in beneficial occupancy or higher TIs, but that is a market-by-market phenomenon. One of the things that is different in this cycle is that owners are well capitalized. These investors can wait and hold their rates.”



*“Pricing has not adjusted to meet buyers’ expectations and sellers aren’t being forced to sell.”*

**JOHN HARTY**  
VOIT COMMERCIAL BROKERAGE

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In terms of rents, the office markets of San Diego, Los Angeles and Orange County all ended last year on an upswing. According to CBRE, overall lease rates for Los Angeles rose 3.5% between the third and fourth quarters, going from \$2.80 a sf per month to \$2.90. During the same period, rents in San Diego climbed by five cents to \$2.42.

Marcus & Millichap projects that annual asking office rents in Riverside and San Bernardino Counties will swell by 3.8% to \$23.48 a sf this year, while effective rents will rise 2.9% to \$20.12. In Orange County, asking rents ended 2007 at \$2.77 per sf a month, up from \$2.52 a year earlier, according to Voit Commercial.

Voit also charted a rise in industrial rents in Orange County, where they landed at 77 cents a sf per month in the fourth quarter, 6.9% higher than the previous year. Inland Empire lease rates increased 7% during the same period and reached 45 cents. In San Diego, average asking prices inflated by six cents between the third and fourth quarters of last year to land at \$1.13 per sf a month, reports CBRE.

For all the turbulence in the national and even state-wide economy, most of those toiling in the commercial real estate trenches of Southern California believe the region will come through this latest slow period relatively unscathed and sooner than expected.

“They used to say California was last in and first out whenever there were any downturns,” Zugsmith says. “Southern California started to slow last year. If we want to call it a recession, it really occurred in the fourth quarter. So I would say we were among the first in. I am getting the sense now that there is a lot of stabilization. People are seeing that the market has bottomed out and if they want to get a good deal, they’d better do it now.” ♦

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