

# INVESTMENT REPORT

SECOND QUARTER 2009

## Small Q2 Gains Hint at Increased Activity to Come

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For real estate market watchers, the first quarter of 2009 was a tough act to follow.

Though the state's transactional volume of deals \$5 million or greater had been on a steady decline since third-quarter 2007, according to *Real Capital Analytics*, a new low was set in the first quarter of this year when \$1.3 billion in deals was recorded across all sectors.

Fast forward to second-quarter 2009. With just \$1.9 billion in sales, there is little cause for celebration. But the figure exceeded that of the prior quarter, and many brokers say it belies the activity they are starting to see in the marketplace.

"Activity has been picking up. There are a lot more users that have come out to the market willing to ink lease deals and take advantage of the decrease in sale prices," said Mark Zorn, executive vice president, *DAUM Commercial Real Estate Services* in Ontario, who specializes in industrial product, which posted a statewide total of \$366 million compared with \$294 million in the previous quarter.

According to *Real Capital Analytics*, at \$690 million in total transactional volume, the office sector led statewide, though multifamily trailed closely with \$618 million. When compared with

the previous quarter, the office, multifamily and industrial sectors posted gains of \$215 million, \$287 million and \$73 million, respectively.

Retail transaction volume, mirroring the sector's woes, dropped \$119 million from the previous quarter to \$198 million.

Fouy Ly, senior vice president, *Sperry Van Ness* in Irvine, said he anticipates retail will experience further deterioration before rebounding.

"Through the rest of the year, we're going to see higher vacancies," Ly said. "We're going to see a higher amount of bank-owned [properties] and a higher amount of stress for the retail ownerships out there. We're anticipating it getting worse before it gets better."

Ly said capitalization rates for retail sales have been all over the board.

"For single-tenants, it's in the 7 percent [range]. For multi-tenants that are small, it's still relatively low in the 8-plus cap rate," he said.

Across the sectors, brokers reported capitalization rates in the mid-6 to 7 percent range, reaching 8 percent in tertiary markets. According to *LoopNet Inc.*, the statewide 12-month rolling average capitalization rates inched up slightly across all sectors to 6.1 percent for retail, 6.5 percent for office, 6.9 percent for industrial and 5.7 percent for multifamily.

The active buyers, brokers said, are largely high-net-worth individuals looking for the bottom.

"This market allows them to compete with institutions because institutions are at a standstill," said Bob Safai, founding partner of *Madison Partners* in Los Angeles. "We are looking at values deteriorated from 20 to 50 percent in some markets. High-net-worth individuals get the full value [because] when you buy an asset you get a depreciation schedule."

Safai said the balance of the buyers mainly is comprised of opportunity funds, while pension funds remain on the sidelines trying to determine allocations.

Though brokers say both sides are inching closer to the middle, in light of diminished values and rising distressed sales, vestiges of the buy-sell gap remain.

Kitty Wallace, senior vice president in the Los Angeles office of *Sperry Van Ness*, quipped some brokers aren't looking for distress — they are looking for road kill.

"There is a group buyers not getting deals done because they have unrealistic expectations," Wallace said.

According to Wallace, the seller group has expanded, but that doesn't mean others aren't trying to wait out the market by holding or refinancing. Sellers, too, range from those whose pricing is unrealistic in this market to others willing to get deals done.

California boasted a second-quarter offering volume of \$12.7 billion — nearly seven times

what closed — according to *Real Capital Analytics*, but Rick Reeder of *Grubb & EllisBRE Commercial* in Carlsbad said there are few office and industrial properties on the market in San Diego County and there has been very little activity, so far, involving troubled assets.

"There is still talk that there will be a tremendous amount of property that comes to the market through foreclosure, the [Federal Deposit Insurance Corp.] or for various debt-related reasons," Reeder said. "But the sellers out there so far are sellers that needed to sell some properties due to fund redemptions or loans coming due."

Some distressed deals are getting done, however, and most expect that trend to continue into the next quarter and the remainder of the year.

For example, following second-quarter negotiations, *Argonaut Private Equity Group* closed on the \$40.8 million note for the distressed 250 Montgomery St. in San Francisco for roughly 50 cents on the dollar — amounting to that region's first major Class A office transaction of the year.

Randy Getz, executive vice president and investment specialist with *CB Richard Ellis* in Sacramento, said it's still unclear how much distressed real estate will be hitting the market.

"It's still an evolving process. We really don't know how the lenders are going to deal with it," he said.

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## Buyers Still Looking in San Diego

RREEF in its July sale of La Pacifica, a three-building, 226,220-square-foot industrial asset in Oceanside, to *DEI LLC* for an undisclosed price.

Grubb & EllisBRE also recently represented the seller of the three-story, 55,000-square-foot Carlsbad Pacifica office building.

Though there are few data points to prove it yet, Reeder said it seems like the office and industrial investment markets are beginning to shift in San Diego County as properties change hands.

"There have not been that many trades, but it does feel like things have bottomed out and we're starting to see buyers and sellers get more comfortable with where things are today," he said. "There doesn't seem to be the same bid-ask gap that we had at the end of last year and beginning of this year."

Reeder estimated that pricing for office and industrial assets is down 25 percent to 35 percent from a year or so ago at the height of the market.

Grubb & EllisBRE reported that industrial vacancy reached 9.4 percent in San Diego County during the second quarter, up from 7 percent a year earlier. There was 2.2 million square feet of negative net absorption in the first half of this year, compared with 469,000 square feet of positive absorption for all of 2008. Asking rents averaged 92 cents per square foot per month in the second quarter, down from 95 cents a year earlier.

The San Diego County office market has seen vacancy rise to 19.7 percent from 16 percent a year earlier, according to *CB Richard Ellis*. Weighted average asking rents dropped from \$2.37 to \$2.31 per square foot per month from the first to the second quarters of 2009.

With fundamentals slipping for San Diego County's shopping centers, capitalization rates for retail assets were up 100 basis points from a year earlier in the second quarter, running from the mid-6 percent to low-7 percent range, as investment in multi-tenant assets slowed this year, according to *Marcus & Millichap Real Estate Investment Services*.

Demand for single-tenant properties is expected to remain steady as investors shift their attention from secondary and tertiary locations to primary markets.

While retail vacancy has crept up from 3.3 percent in the second quarter of 2008 to 4.9 percent in second-quarter 2009, according to *Voit Real Estate Services*, asking rents dropped from \$2.08 per square foot per month in second-quarter 2008 to \$2.05 in first-quarter 2009 and remained at the same level in the second quarter of this year.

Apartment rents in San Diego County have also slipped since last year, according to *Novato-based RealFacts*. Average monthly rents declined 1 percent in the second quarter on a year-over-year basis to \$1,379 and occupancy dropped 2.1 percent to 93.5 percent.

Lou Bulte of *Privado Capital Group* in San Diego said apartment sales activity in 2009 has been flat compared to last year as buyers' capitalization rate expectations rise and sellers remain unrealistic about their pricing.

Bulte, while still with *Coldwell Banker Commercial - North County*, represented *Palomar Apartment Homes LP* with general partner *Devkor Properties* in its \$5.5 million sale of a 34-unit apartment complex on Palomar Street in Chula Vista to the *Reicht Family Trust* in a transaction that closed June 22 at a 6.7 percent capitalization rate.

He said there are not a lot of institutional investors looking to buy apartments in San Diego right now, so the market is dominated by private

buyers looking to reposition their portfolios after breaking up with an investment partner or moving on from Class C to B assets.

"We could be looking at very light transactional business for a while until there's some equilibrium set, either through the capital markets being better on underwriting or sellers being willing to drop their price," Bulte said. "I don't see buyers being too much more aggressive than they are right now."

*The Prime Group*, a private San Francisco-based investment company, spent \$52 million for the 424-unit *Villages of Monterey* and \$32 million for the 234-unit *Montecito Village*, both in Oceanside, during the second quarter.

"These two sales mark the beginning of a trend where private investment firms will move to acquire quality, institutionally owned properties in fundamentally sound markets at today's lower price points," said Ed Rosen, executive director with *Cushman & Wakefield* in San Diego, when the transactions closed in April.

Rosen, John Chu and Alejandro Lombrozo of *Cushman & Wakefield* represented the buyer and seller, *Northwestern Mutual Life Insurance Co.*, in the transactions.

Reeder said institutional investors mostly have been on the sidelines in San Diego County's office and industrial market, but high-net-worth individuals and private investment funds that were out of the market for the last few years have come back.

"They have quite a few equity dollars, so they're buying all-cash or at such a low level of debt that they can do it," he said.

Reeder expects investment activity to remain flat this year, with troubled debt-related transactions beginning in 2010 to help start the market's slow recovery.

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DEI LLC paid RREEF an undisclosed price in July for La Pacifica, a three-building, 226,220-square-foot industrial asset in Oceanside.

BY MANDY JACKSON  
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Though there has been some recent investment activity in San Diego County, brokers expect transaction volume to be flat for the rest of the year.

The data show less property traded hands in second-quarter 2009 than during the same three-month period in 2008, but investors appear to be in the market now looking for bargains and making some deals.

There were no industrial transactions in San Diego County priced above \$5 million in the second quarter, according to New York-based *Real Capital Analytics*, though there were \$114.8 million of industrial deals in second-quarter 2008 and \$546.2 million in second-quarter 2007.

Among other property types in San Diego County, \$113.9 million in apartments and \$50.5 million in office buildings traded hands in the second quarter, down from \$165.4 million in apartments and \$161.6 million in office assets in second-quarter 2008, according to *Real Capital Analytics*. Second-quarter retail investments grew from \$13.9 million to \$32.8 million in the past year.

There may have been no large industrial transactions in the second quarter, but Rick Reeder of *Grubb & EllisBRE Commercial* in Carlsbad was part of the team representing