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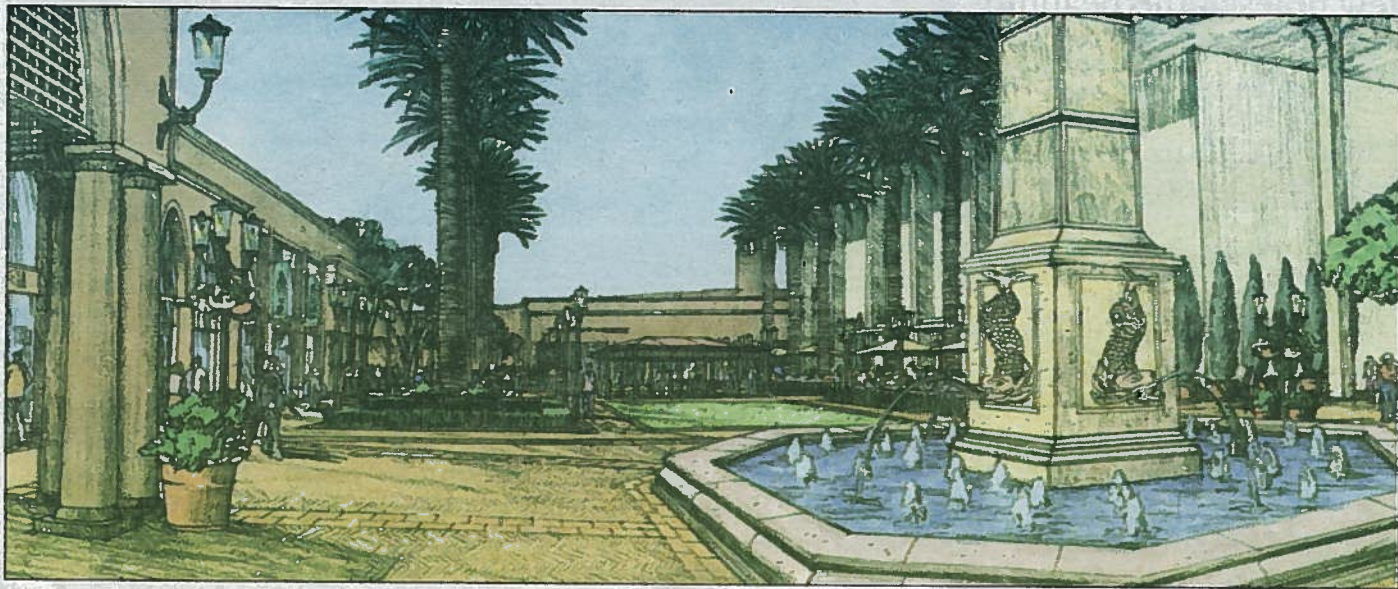
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MIDYEAR UPDATE

RETAIL



The Irvine Co. is planning new stores and architectural enhancements at its 42-year-old Fashion Island shopping center in Newport Beach.

Recession Keeps Pressure on Retail

Housing correlation reflected in vacancies, stalled projects

BY JULIE NAKASHIMA CREJ Staff Writer

At the beginning of this year, retailers were feeling consumers' economic pain as rising vacancies, store chain bankruptcies and an emphasis on value-oriented shopping were the key trends. Six months

later this is just as true, if not more so. Shopping centers in the newer housing markets are struggling for tenants and major retail development projects languish on hold. Scott Crowle, vice president of investments and associate director of the National Retail Group at Marcus & Millichap Real Estate Investment Services, pointed to Sacramento as an example of a

MIDYEAR UPDATE

HOSPITALITY

DISTRESS MAY BREAK HOTEL INVESTMENT LOGJAM IN SECOND HALF OF 2009 PAGE 6

region that grew rapidly during the housing boom and now is leading

the decline in retail fundamentals versus more developed regions like Orange County where retail has fared better.

"If you look at the top 10 residential foreclosure markets in the country," Crowle said, "you could draw a pretty exact correlation to the struggling retail markets."

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GUEST COLUMN

Proposed Guideline Changes to Clarify Trial Court Decisions Addressing Climate Change Under CEQA

BY WILLIAM R. DEVINE AND SHANDA M. BELTRAN

As lead agencies and project applicants struggle with how best to address climate change under the California Environmental Quality Act, the Governor's Office of Planning and Research has submitted proposed amendments to the guidelines regulating preparation of environmental planning documents under CEQA. The proposed amendments are not yet finalized, but once adopted should help to clarify the differing approaches to addressing climate change in CEQA documents. The guidelines provide direction that had been, until recently, only provided in disparate trial court decisions that left the regulated community guessing as to how to deal with the climate change issue. Summarized below are four decisions that took different approaches to climate change issues in the CEQA context.



DEVINE

Riverside and Los Angeles Courts Reject Find Flaws in CEQA Documents That Fail to Adequately Address Climate Change Impacts

In Center for Biological Diversity et al. v. City of Desert Hot Springs, et al., the court invalidated an environmental-impact report for failure to make a meaningful attempt to analyze a project's effects on global climate change. Finding that California had recognized the importance of combating global warming, the court rejected an argument that analysis of global warming impacts for a new development project would be speculative given a lack of adopted guidance, framework or analytic tools or methodologies for conducting climate change analyses from regulatory agencies. While acknowledging that a "too speculative" finding is theoretically possible, the court found that the EIR did not make a meaningful attempt to analyze climate change issues before concluding that the analysis was speculative.

In Natural Resources Defense Council, Inc. v. Inland Energy, the court

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THE NEXT LEVEL DEVELOPMENT

FAMOUS FOOTWEAR FINDS LOGISTICS SOLUTIONS AT TEJON PAGE 13

ROUNDTABLE

GREEN DEVELOPMENT



This special sponsored section brings together a panel of six experts to explore green development.

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DEVELOPMENT

Industry Braces For New Climate Change Regulation

Proposed rule gives AQMD authority to approve, deny projects

BY KARI HAMANAKA CREJ Staff Writer

Commercial real estate already faces an onslaught of climate change regulation. Now a proposed rule seeks to fundamentally alter Southern California's land-use landscape by giving project approval authority to a state agency.

The South Coast Air Quality Management District is looking to regulate nitrogen oxide emissions under its Proposed Rule 2301. The rule would require developers to submit plans documenting nitrogen oxide emissions and mitigation measures for AQMD review and approval.

"Lots and lots of projects are going to have to submit approval plans," said Sean Sherlock, partner at Snell & Wilmer LLP in Costa Mesa, speaking at a NAIOP Inland Empire event last month. "On top of all the approvals we already have to get, developers now have to get AQMD's approval."

The concern is the amount of power the rule allows AQMD over development as the California Air Resources Board and regional Council of Governments already are in the process of implementing Assembly Bill 32 and Senate Bill 375, which will impose significant development rules.

"AQMD has never regulated real estate before," Sherlock said. "As a result of this, it is going to impose another layer of regulatory approval."

AQMD has the ability to make comments and add its input during the California Environmental Quality Act process. If passed, PR2301 would be the first land-use rule for the district, which includes Los Angeles, Orange, Riverside

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## RETAIL

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Sacramento is a microcosm of this trend: The city proper is pretty much built out. But growth areas such as South Placer, Rocklin and Lincoln have gotten roughed up, retailwise. The projects that are distressed are the ones that were newly built and weren't able to be filled because they were built on speculation.

Lincoln and Rocklin, which lie adjacent to each other, have a retail vacancy close to 20 percent.

"The Sacramento market has experienced above-average unemployment, and we definitely felt that trickle down," Crowle said. "There are some scary little corridors out there in terms of being a little bit too late in the growth cycle."

He said net operating income numbers have gone down as vacancy rates have gone up, and transactional velocity has slowed to the point of stagnation. Most of the deals that have taken place have been owner-user deals, where the buyer could take advantage of Small Business Association financing.

"Cap rates are definitely going up," he said. "You have buyers who are anticipating a bottom, which most feel we have not reached out."

In addition, strong credit tenants continue to renegotiate their leases, and not just because of the obvious things like tight credit markets and a curb in consumer spending. Crowle noted that many healthy companies have maturing debt, which puts them in a precarious position.

"As a result, you have these healthy companies in these Class A trophy locations that are having to renegotiate their leases," he said.

Like other markets in California, he said the Sacramento area has lost a number of fairly sizable spaces because of the Mervyn's and Gottschalks bankruptcies. Kohl's and Forever 21 were able to absorb some of these vacancies, but others still remain.

The danger of losing these bigger tenants, Crowle said, is that you can potentially lose the smaller tenants as well because of the co-tenancy clauses in some of these leases. As a case in point, he pointed to a Starbucks that was able to get out of a lease in a shopping center in Rocklin because the Mervyn's store closed.

"Vacancy in that sense breeds vacancy," Crowle said.

## Warning Signs

Despite the overall cooling trend, the second quarter saw some encouraging warming signs.

Fouy Ly, a senior vice president with Sperry Van Ness in Irvine, said transactional activity in the beginning of the year was quiet. In the second quarter he began to see some transactions happening.

"The market is stirring a bit," Ly said.

As evidence, he cites former superstar Realtor Fred Sands' \$50 million acquisition of the South Bay Pavilion, a 1.1 million-square-foot mall in Carson, and Westlake Village-based DSB Properties' \$45 million purchase of Old Ranch Towne Center, a 144,726-square-foot center in Seal Beach.

In Northern California, Ly said that Kimco and others are closing sales of market- and drug-anchored centers at capitalization rates higher than 10 percent. In Southern California, it's primarily the smaller stuff — single-tenant and strip center deals that are closing, with capitalization rates in the 7.5 percent to 8 percent range.

Sellers in Northern California were the first ones to get hit by the downturn, Ly observed.

"The seller has become a little more realistic in those markets, so the cap rate is a lot higher," he said.

Phil Lyons, principal and retail sales specialist in the Carlsbad office of Grubb & Ellis | BRE Commercial, said shopping center vacancies in San Diego increased across the board during the first half in virtually every submarket. From Jan. 1 to June 30, the overall vacancy rate jumped to 5.6 percent from 3.2 percent, he said.



Westfield Group's Horton Plaza is one of two San Diego area malls with planned renovations put on hold due to the economy. Phil Lyons of Grubb & Ellis | BRE Commercial anticipates few large projects will start or be completed in the San Diego area during the last six months of the year, though smaller sites going through the approval process may break ground in the fourth quarter.

At the same time, he is seeing some encouraging signs that the stalemate in leasing activity may be easing.

"During the first half, tenants were just in shock and weren't sure what direction to go," Lyons said. "Some have decided to do nothing or to expand, but decisions have been made at least."

The increased vacancy has put more spaces on the market, giving retailers more alternatives and suppressing rents, which have declined anywhere from 10 percent to 25 percent. Meanwhile, leasing volume from January through mid-year is down 10 percent to 15 percent.

But Lyons said the volume seems to be picking up over the last 60 to 90 days, with tenants looking to penetrate markets that they haven't been able to yet.

"Tenants are looking to relocate," he said. "In addition, we're seeing new tenants or existing tenants that are new to the market."

Specifically, he said Five Guys Burgers, Total Wine and WinCo are looking to expand in the San Diego market. Souplantation is an existing tenant in the trade area but is taking advantage of the economic conditions and rolling out a new, smaller format of 4,500 square feet, compared with its typical 7,000- to 8,000-square-foot restaurant.

Lyons said tenants are negotiating much harder deals.

"Where there once was only one opportunity in a specific trade area, now there are multiple opportunities in trade areas," he said. "Tenants are putting out multiple offers in the same trade area in order to negotiate the best deal and play one landlord against another."

Investment sales activity in triple-net-leased investments, such as fast-food drive-through restaurants and standalone drug stores, still seemed to be good during the first half, he said. But sales transactions for larger neighborhood or community shopping centers in San Diego were virtually nonexistent.

There are some projects currently on the market, Lyons said.

"For the second half of the year, hopes are that some of the shopping centers will sell, which will give us new data points to let us know where the equilibrium point is between buyer and seller," he said. "People will be able to look a little bit more at what it takes to get a transaction done."

Ly agreed. He noted that the gap between buyers' and sellers' expectations is getting smaller, although it's mainly sellers moving their expectations rather than buyers at this point.

"The market is trying to work itself out, and the sellers have become a little more realistic about pricing," he said. "It's getting closer, but it's just not there yet for a lot of transactions to happen. We're waiting for the second half, when we think there are going to be a lot of problems with tenants, a lot of retailers filing for bankruptcy and putting landlords into REOs."

## Breaking Ground

Overall, new construction projects continue to be few and far between, but pockets of activity can be found here and there.

Phase II of the retail portion of a huge mixed-use development in Ontario by Panattoni Develop-

ment still is on hold. CB Richard Ellis, which was leasing the Piemonte's 500,000-square-foot retail component, reports it is not actively working on the project at this time.

In San Diego, Westfield Group had plans to expand and remodel Horton Plaza and UTC Mall but put those projects on hold due to the economic environment. Lyons said nothing new has started or been completed within the last six months.

He anticipates more of the same for the second half of the year, with the exception of some smaller, two- or three-acre sites that are going through the approval process and should break ground in either the fourth quarter of this year or first quarter of next year. These projects typically will be drug store- or fast food-anchored, with three or four freestanding buildings and minimal or no inline shops, he said.

But in Sacramento, Crowle said a couple of major downtown urban infill projects are getting under way. Thomas Enterprises Inc. broke ground on infrastructure for The Railyards, a 240-acre mixed-use project on Sacramento's historic Railyards that will include 1.3 million square feet of retail, restaurants and entertainment, mixed-use high-density housing and 2.9 million square feet of office space, theaters, fine arts venues, parks, hotels, museums and historic buildings. Meanwhile, a 65-acre mixed-use project called Township 9 also has broken ground near the Railyards.

And Petrovich Development has started cleanup work for Curtis Park Village, a mixed-use housing, office and retail project being built on a portion of the Union Pacific railyard near downtown. The project will include about 188,000 square feet of neighborhood-serving retail.

In Orange County, The Irvine Co.'s high-end Fashion Island center in Newport Beach is undergoing a major renovation that includes the opening next spring of a Nordstrom department store. The Newport Beach-based company describes the project as an "end-to-end program" encompassing architectural enhancements, updated landscape and hardscape, new water features and more for the 42-year-old shopping center.

In a statement, Keith Eyrich, president of Irvine Company Retail Properties, said the planned new stores, improved outdoor people spaces and dramatic new touches to the center's Mediterranean-style architecture would result in an enhanced guest experience.

"The current reinvestment grows out of our long-term commitment and vision for Fashion Island, as well as a strong belief that it will remain one of the nation's most successful and appealing outdoor retail centers," Eyrich said.

As an example of the changes planned over the next year, the courtyard between the Neiman Marcus and Bloomingdale's stores will be spruced up with a hand-carved granite fountain inspired by the Fountain of the Four Rivers in Rome's Piazza Navona. A classical pavilion built in Italy will serve as the area's focal point and provide a community gathering place.

## Preparing for Troubled Assets

Dixie Walker, a senior vice president in the Newport Beach office of Grubb & Ellis, drew a contrast between the county's office and retail sectors. The

office sector got hammered because of the preponderance of tenants that were in the mortgage and finance businesses.

But in retail, Orange County from an investment standpoint has actually fared better than a lot of other areas, he said.

"One of the major issues in any market today is the difference between the bid and the ask," Walker said. The buy side is trying to figure out where capitalization rates will end up, and reticent to buy at rates they think are going to be below where the market will eventually settle.

"Tied to that is the closed versus offered portion of the investment market," Walker said. "And Orange County has a much higher ratio than virtually any place in the Southwest that I've seen."

In terms of larger properties, he said there were nine properties offered and five closed, or 56 percent. That compares to Los Angeles, which had an offered versus closed percentage of 11 percent, or nine out of 80 properties, and the Inland Empire, which had a ratio of 16 percent, or five out of 31 properties.

"So there's a lot to be said for what Orange County has proven itself to be, which is one of the better places to invest," Walker said. "Things are in fact moving at a higher rate in Orange County at the moment."

The trends going forward in Orange County are going to be affected by how many distressed retail properties make it to the market, he said, adding this is true in any market. And when the transaction volume reverses direction and the bid-ask gap closes, the increased activity will cause a pricing rebound and things will get back to a more normal pattern.

"But what needs to be collated into that picture is the amount of distressed properties which hit the market, which will in turn drive prices," Walker said.

That flow is not determinable at the moment, he said. While Orange County has not seen a lot of foreclosed and trouble assets come onto the market, no doubt there will be some. Walker expects it will be somewhere between a trickle and a flow.

"There will be a lot of loans coming due over the next two to three years that have to be resolved, hopefully at the servicing level for the owners," he said.

General Growth Properties hasn't wreaked as much havoc as one might expect from the Chapter 11 bankruptcy of one of the nation's largest mall owners. General Growth has centers in Chula Vista and Otay Mesa in south San Diego County, but Lyons said the bankruptcy "hasn't affected the retail landscape in San Diego in any significant way."

In Sacramento, Crowle cites a rather fortuitous situation in which tenants that had signed leases in a General Growth project in Elk Grove that stalled were able to find space in the Palladio, a project that Harry Elliott Homes is building in nearby Folsom. Anchored by Whole Foods and Barnes & Noble, both of which recently renegotiated their leases, The Palladio also has a 16-screen Cinema West theater complex scheduled to open in October 2010.

Discounters and value plays continued to do better than the high-end or luxury segments in the first half. According to Lyons, fast-food tenants are increasing their sales because people are "shopping down."

"People that normally would go to a Chili's are now going through the drive-through at McDonald's for their night out," he said.

Indeed, Crowle said one of his retailer clients, Goodwill, is a perfect example of a tenant that wanted to grow but was unable to previously, and now is the perfect time for it. For many years, it was stigmatized by its thrift shop image, he noted, although it has freshened up and modernized its concept with signage and brightly lit locations.

"They weren't the classic sexy tenant you want in your center, but the retail world is changing very quickly," Crowle said. "In many circles, frugal is chic."

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