

INVESTMENT REPORT

THIRD QUARTER 2009

California Markets Have a Faint Pulse in Q3

BY MICHAEL GOTTLIEB
CREJ Editor

For California commercial real estate professionals searching for signs of life in the investment market, they found it in the third quarter. You just need a stethoscope to detect it.

Total commercial real estate transactions of more than \$5 million hit \$2.78 billion this past quarter, according to Real Capital Analytics, an increase of 40.5 percent from the prior quarter and the strongest quarter in a year. The transactional uptick was seen across the board, with each of the four primary product types posting better performance than the prior quarter and puts California on par with the rest of the world, which saw global property sales volumes increase 40 percent quarter to quarter, according to Real Capital.

"In the first two quarters [of 2009], you really didn't see too much activity from the investment market," said Mano Leventakis, executive vice president and managing director of Grubb & Ellis' Ontario and Riverside offices. "But you're starting to see some form of activity as we close out the year and as we head into 2010."

One quarter of improved performance does not mean that the California commercial real estate investment market is off life support, however.

"It's been pretty dry because owners that don't have to sell, don't want to sell," said CB Richard Ellis Vice Chairman Darla Longo.

Despite the improved performance, third-quarter transactions were down 46.6 percent from a year ago, and down more than 83 percent from third-quarter 2007 when the real estate markets began to slow down from the start of the credit crunch.

"During the frenzy of the market, a lot of buyers were going into deals with their eyes closed and they were counting on the market to solve whatever problems they may have," said Kent Williams, first vice president and regional manager at Marcus & Millichap Real Estate Investment Services in San Diego. "Now their eyes are wide open and they're looking for a deal, not priced below market but well-maintained and -managed properties where the rents are not at the top of the market. They're not looking to rob anybody blind, but they're looking for a fair deal."

California values have fallen in all property

types due to the lack of investor demand, limited financing and eroding fundamentals. According to LoopNet, the average capitalization rate over the past 12 months for the four top priority types hit 7.03 percent in the third quarter, up 20 percent from a year ago, when the average cap rate was 5.85 percent.

"Values are down and capitalization rates are up," said Darcy Miramontes of Grubb & Ellis/BRE Commercial in San Diego. "I don't think we're going to see 5 caps again, but we think they're going to bump along flat and maybe go up and down just a little bit, but they will be higher than they were."

The outlook is complicated by conflicting signals. For example, the latest Real Estate Roundtable's sentiment survey of current and future conditions increased by 15 points to 63 and California's commercial loan delinquency rate declined to 0.23 percent in the third quarter from 0.26 percent in the second quarter, according to the California Mortgage Bankers Association. A year ago the delinquency rate was 0.08 percent, however.

"Deals are being sold, but sellers need to be realistic about where the market is, and buyers

need to be realistic about the amount of distress there is and the amount of discount they are going to get," said Joseph Cesta, regional manager for Marcus & Millichap's Newport Beach office. "We believe there will be a surge as we head into the holidays and toward the end of the year."

Most brokers believe that the uptick in transactions will correspond to an increase of distressed real estate in the market, which has been limited despite the extended economic and real estate downturn. That will help close the gap between buyers and sellers, which has narrowed somewhat over the course of the year.

"In six to eight weeks, we will probably see a couple more reasonably priced buildings on the market," said David Doupe, an international director in the Los Angeles office of Jones Lang LaSalle.

According to Grubb & Ellis' Dain Fedora, private investors are working with real estate investment trusts to gear up for the wave of foreclosures hitting the market at the end of 2009.

"To use the cliché, it's the calm before a storm," he said.

— E-mail Michael.Gottlieb@DailyJournal.com



1402-1408 E. Main St., El Cajon

BY MANDY JACKSON
CREJ Staff Writer

San Diego County has many buyers looking for investment opportunities but too few sellers putting properties on the market to satisfy demand.

Investment activity increased in the third quarter from low levels in the second quarter, but transaction volume still is a fraction of sales levels seen in previous years.

Louay Alsadek, executive vice president at CB Richard Ellis in San Diego, estimated that San Diego County investment volume this year is about 15 percent of the average annual sales volume from 2004 to 2006. Sales activity next year may be two or three times as much as this year, but that figure still will be down from previous averages.

The volume of commercial real estate transactions above \$5 million increased for three out of the four major property types in San Diego County between the second and third quarters, according to Real Capital Analytics.

Industrial investment jumped from zero to \$72.9 million, office transactions rose from \$42 million to \$124 million and retail volume increased from \$32.8 million to \$34.5 million. Apartment sales dropped from \$119.4 million to \$46.6 million, but transactions for the property type totaled \$240.7 million for the first three quarters of the year, topping office at \$212.3 million, industrial with \$134.8 million and retail at \$101 million.

Among third-quarter transactions, KM Development-72 sold 104,213 square feet of retail and industrial buildings in the Convoy - Ronson Plaza and Industrial Park to a private family trust for \$12.3 million in the Kearny Mesa submarket of San Diego.

Alsadek said there are buyers who were not

active six months ago that now want to buy properties. They're focused on assets foreclosed on by lenders and the small number of trophy properties that are listed for sale. However, there are so few distressed assets on the market that some buyers are willing to pay a slight premium for those deals.

"A lot of people are looking to buy, but there's not a lot of product," Alsadek said. "We're getting so many buyers that want to buy, that have hundreds of millions of dollars to spend over the next two to three years. I don't think there's going to be enough distress for everybody."

Mike Hoeck, vice president at CB Richard Ellis in San Diego, said the office leasing market appears to be hitting bottom in terms of the amount of space available.

"We don't anticipate any further dramatic declines," Hoeck said.

However, it likely will be a year or two before rental rates recover from recent declines. Rents are expected to drop another 10 percent before they rebound.

Companies in Kearny Mesa, Sorrento Mesa and other strong San Diego submarkets have been fairly stable throughout the recession and now some of those employers are looking for expansion space, Hoeck said. Many tenants are hoping to move out of Class B or C space and take advantage of reduced rents for Class A space.

San Diego County office rents dropped to \$2.47 per square foot per month in the second quarter, down from \$2.73 a year earlier, according to Grubb & Ellis/BRE Commercial. The brokerage reported direct vacancy of 18 percent in the third quarter, up 300 basis points from a year ago. Absorption was negative 220,158 square feet in the third quarter, bringing the year-to-date total to 940,463 square feet of negative absorption.

Many Investors, Too Few Sellers in San Diego County

In the industrial market, Voit Real Estate Services reported third-quarter vacancy of 8.6 percent, average rents of 67 cents per square foot per month and 1.1 million square feet of negative absorption in San Diego County. A year earlier, the market had 6.3 percent vacancy, average rents of 74 cents and 277,732 square feet of negative absorption.

Voit reported higher third-quarter vacancy in the research-and-development sector at 16.5 percent, with rents averaging \$1.25 and negative absorption of 163,631 square feet. A year earlier, research-and-development properties were 11.7 percent vacant, with average rents of \$1.43 and 106,010 square feet of negative absorption.

Britannia Crossings LLC sold two industrial condominiums totaling 23,482 square feet at 7577 Airway Road to Francisco Gutierrez Mercado for \$2.3 million in the third quarter. The property is in the 150,000-square-foot Britannia Crossings complex in Otay Mesa.

Office and industrial properties seem to have fallen behind apartments in the eyes of private investors, according to Kent Williams, first vice president and regional manager at Marcus & Millichap Real Estate Investment Services.

Williams said the biggest pool of buyers in the market are opportunistic. They're looking for properties in good locations at decent prices, knowing that not every transaction will look like a steal.

"If it's an A or B-plus or B location, as long as it's priced reasonably, then it's going to sell," Williams said. "If you go to B-minus, C or D, you're really looking at heavy discounts in price per square foot or per unit."

Despite a 25 percent drop in the velocity of apartment sales, the median price in multifamily transactions dropped only 1.3 percent from \$121,400 per unit to \$114,400 per unit on a year-over-year basis in the third quarter, according to Marcus & Millichap.

In terms of performance, San Diego County apartment rents averaged \$1,376 per month in the third quarter, down 2.1 percent from third-

quarter 2008, according to Novato-based Real Facts. Occupancy was 94.3 percent in the third quarter, representing a 1.6 percent year-over-year decline.

Darcy Miramontes of Grubb & Ellis/BRE Commercial in San Diego said beginning of 2009 was very slow for San Diego County apartment investment, but activity picked up in the latter half of the third quarter and has continued into the fourth quarter.

"We have a lot of buyers who've put together funds or syndications or who have cash on hand that have been on the sidelines and they're willing to buy in the San Diego market," Miramontes said. "There just hasn't been a lot of quality product on the market."

Many of the multifamily properties on the market in San Diego County this year involve distressed sellers, lesser-quality buildings or bank-owned assets.

"The high-leverage, low-cash buyer is out of the market," she said. "More often than not it's an all-cash buyer or a lower-leveraged, well-funded, seasoned buyer who knows the market."

Nationally, Williams said investors are sticking to investments deemed to be safe, especially retail properties with long-term leases and single-tenant, net-leased assets.

LIAD LLC paid \$13.8 million during the third quarter to EVALBS LLC for the 42,973-square-foot Albertson's grocery in downtown San Diego at the base of the Market Square Village apartment complex in the East Village during the third quarter.

Vacancy in San Diego County's retail sector grew from 5.5 percent in the second quarter to 6.2 percent in the third quarter, according to CB Richard Ellis. Rents averaged \$2.12 per square foot per month in the third quarter, down 4 cents from the previous quarter, and the market saw 434,374 square feet of negative net absorption, though the decline was smaller than in the first and second quarters.

— E-mail MJackson@DailyJournal.com