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REAL ESTATE: Foreclosures spread into office market

Rising number of vacancies stokes agents' fears

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A real estate report this week showed North San Diego County companies continuing to downsize, underscoring analysts' recent warnings that foreclosures could sweep through office parks and saddle banks with a new batch of souring loans.

Businesses vacated 165,000 square feet in the second quarter, driving the local vacancy rate to 26.9 percent from 24.5 percent in the first quarter, according to a report by Grubb & Ellis BRE Commercial brokerage. Vacancy varied widely, from 19 percent in Escondido to 34 percent in Rancho Bernardo.

Real estate brokers consider vacancy of 5 to 10 percent to be normal and healthy in the local market.

Compounding the problem for landlords is the large number of new office buildings that were launched in the months before the economy slowed, for example in Carlsbad's Bressi Ranch development. About 1.8 million square feet of office space came onto the North County market in the last two years, according to Grubb & Ellis. About 140,000 square feet of office space is under construction.

Justin Halenza, a sales and leasing agent with the brokerage in Carlsbad, said he expects vacancies to rise by another couple of percentage points, with the average remaining near 30 percent for a year or more.

"I don't see the commercial market coming back until we see the unemployment stop," Halenza said. "We need job creation."

San Diego County's service sector has cut 28,000 jobs since June 2008, when employment peaked at 989,000, according to the California Employment Development Department. Those numbers include a wide range of industries from accounting to medical practices, but not retailers.

Halenza said technology and life sciences are among the relatively few industries with expanding companies.

Loans issued through most of this decade provide commercial landlords with thin cushions against the pain of falling lease revenue, banker Gary Votapka said.

Ratios of rental income to debt service as low as 1.2 to 1 were common, said Votapka, chief executive of Mission Oaks National Bank in Temecula and Fallbrook. In other words, lenders regularly approved loans whose monthly payments would be as high as 83.3 percent of the borrower's average rental income at the time of application. In such cases, a landlord is at risk of loan default and eventually foreclosure when vacancies or troubled tenants cause rental income to fall by more than 16.7 percent.

A total of 49 North County commercial properties, representing \$88.7 million in loans, were in various stages of the foreclosure process last week, according to a search of ForeclosureRadar.com, a tracking service. Eighty-one local properties entered the foreclosure process in the last 12 months, up from 57 in the foregoing 12 months.

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Those numbers pale in comparison with the thousands of North County homes that have fallen into foreclosure in the last couple of years, but they may understate the size of the problem because lenders are hesitating to foreclose, according to people who follow commercial real estate.

"The game is 'extend and pretend,'" economist Christopher Thornberg said.

Commercial foreclosures are beginning to have an effect similar to ---- albeit less direct and severe than ---- that of home foreclosures because consumers tend to spend less as the value of their investments shrinks, Thornberg said.

Americans own commercial real estate through participation in pension systems such as CalPERS and by owning shares in publicly traded real estate investment trusts. Such companies with shrinking value include Kilroy Realty Corp., which owns 12.5 million square feet of commercial space in Southern California, including 5 million square feet of offices in Carlsbad, Carmel Valley, Sabre Springs and elsewhere in San Diego County. The company's market value has gone from \$1.7 billion to about \$675 million in the last year.

And Kilroy's vacancy rate is not especially high ---- about 17 percent for its buildings in San Diego County as of Dec. 31, according to its annual report to financial regulators.

County officials say they expect declining values of commercial real estate to erode property tax revenue in the fiscal year that begins July 1, 2010, following a similar impact among residential properties in the current tax year.

Local commercial buildings in foreclosure range from a retail property on El Camino Real in Encinitas to an 800-square-foot space on Escondido Boulevard in Escondido.

One is a 7,000-square-foot office building on High Bluff Drive in Carmel Valley. The owner borrowed \$26 million in November 2007 while preparing for renovations, but defaulted on the loan in April 2009 as vacancies rose toward 50 percent, a representative said.

Vacancies aren't the only pitfall for commercial landlords, people in the industry say. Developers rely on construction loans with terms of 18 to 24 months, expecting to refinance into longer-term loans once construction is complete.

Some developers who borrowed in 2007 and early 2008 are having unexpected trouble, both in arranging new loans and in getting enough tenants, people in the lending industry said this week. Lenders were happy for the buyer of a commercial building to put in 5 to 20 percent of its own money one and two years ago, but now 25 to 60 percent is the norm, these people said.

"Anything that was built in the last two, three years is probably most at risk," Votapka said.