

Retail still best real estate market, followed by industrial and office

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While San Diego County's office market will continue to suffer due to the recession, industrial is a bit better, and retail is surprisingly strong, even with the upcoming store closures, according to a new **Grubb & Ellis** forecast.

"The San Diego economic marketplace has proven to be well diversified and prepared to weather an economic downturn that will most likely last over the next two years until some type of clarity is reached in the financial markets," Grubb & Ellis (NYSE: GBE) stated.

Office

With a millions of square feet of vacant office space from Carlsbad to the Interstate 15 Corridor to downtown San Diego, the good news is developers aren't in a rush to construct new buildings.

The bad news is that with wave after wave of job layoffs, many landlords can't keep the buildings they own filled.

"Overall tenant demand will remain slow in 2009, with demand driven by tenants seeking to take advantage of softened market conditions and relocate to higher quality work environments," G&E wrote.

"Lower priced submarkets may see increased leasing velocity as demand from tenants downsizing and relocating from higher priced submarkets is expected to increase," the forecast said.

The report said prospective tenants, as a result of their strong position and desire to keep costs down, are also becoming more attracted to buildings certified as LEED (Leadership in Energy and Environmental Design).

The 300,000-square-foot La Jolla Commons in the University Towne Centre (UTC) market and the 375,000-square-foot Sunroad Centrum in Kearny Mesa, which is largely leased, are both examples of LEED buildings.

Building green is also a trend in San Diego's biotechmarket with projects such as the **BioMed Realty Trust's** (NYSE: BMR) 83,000-square-foot building for **Illumina** (Nasdaq: ILMN) on Towne Centre Drive in the UTC area and **Arena Pharmaceutical's** (Nasdaq: ARNA) building in Sorrento Mesa.

With venture capital funding very much a question mark, the trend will be toward remodeling existing office and lab space at least through 2009.

Biotech companies have also altered the way they conduct business by outsourcing lab space and thereby requiring less specialized office space.

Industrial

The 2008 statistics for San Diego's industrial market revealed some positive signs, despite the softening of the national economy and the slowdown in the real estate market generally, the report said.

The 1.3 million square feet of net industrial absorption in the first three quarters had already surpassed last year's 1.2 million square feet.

Otay Mesa was expected to surpass its 1.1 million-square-foot absorption record logged in 2006 by the time last year drew to a close.

In the Central County, where aging space is meeting up with some still very expensive land, uses are morphing from industrial to office.

Kearny Mesa and Rancho Bernardo are two of these submarkets in the midst of just such a transition.

Five of the seven North County industrial submarkets are positioned very well, with vacancy rates ranging from 4.5 to 6.4 percent.

Carlsbad (about 12 to 14 percent) and Oceanside (10 to 12 percent) are the only submarkets with a vacancy rate above 10 percent.

Industrial leases in the county are typically averaging 20,000 to 30,000 square feet.

Bad economy or not the San Diego industrial leasing vacancy isn't expected to increase more than 1 percent due to low construction levels, and should outperform many other national markets.

Retail

Although San Diego has been ranked better in the past as a top retail market than the ninth place Grubb & Ellis gave it this year, San Diego County is expected to hold its own despite national store closures such as **Mervyn's**, **Linens 'N Things**, and some **Circuit City's**.

The higher income households here are expected to counter the effect of the loss of lower-end retailers.

"The highest income areas within San Diego such as La Jolla, Del Mar and Encinitas are expected to weather the storm better as tenant demand is expected to remain strong," the report continued.

"The areas within South County will experience slower activity in 2009 due to residential issues such as the highest home foreclosure rates in the County," Grubb & Ellis said.

A diverse economy is expected to lift many if not most boats, however, and limited land should keep the market in check, the report added.

Bad economy or not, **Westfield** is moving to expand malls from Horton Plaza to UTC to its North County property.



Investment

The dicey economic situation does mean investors will take longer to scrutinize the underwriting of each transaction and will pull back quicker than in the past.

"However, overall investment activity is expected to increase by 15 to 20 percent, in part due to distressed sales and cash-rich buyers completing transactions ..." the report said. "Well-established banking relationships that have survived the credit crunch will be more important than ever."