

*MARKET HIGHLIGHT, JULY 2010*

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**DIEGO**

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Led by the multifamily and retail sectors, San Diego commercial real estate is primed to shine again.

**Multifamily**

With modest job and economic growth, the multifamily market is expected to lead the commercial real estate recovery, and San Diego remains one of the strongest multifamily markets in the country. Traditionally, San Diego's largest pool of renters consists of students, military dependents, working-class families and the Generation Y demographic. However, with the housing crisis and high unemployment rate, an increased number of Baby Boomers and aging residents have also made renting an economic and lifestyle choice. For the next several years, San Diego is expected to maintain numerous barriers to entry, including high land costs, limited land availability and a high cost of living. Contributing most to the apartment renter pool is the largest and fastest growing Generation Y population of 900,000, and according to SANDAG, this age group is forecast to increase 5.5 percent just this year.

According to MarketPointe Realty Advisors, San Diego County's vacancy rate was 4.75 percent in March, marking an increase of 2.17 percentage points since the start of the recession in fourth quarter 2007. However, it is well below the national average of 8 to 10 percent for major MSAs.

San Diego's current countywide rental rate of \$1,315 increased 4.33 percent from March 2007 to March 2010, with a decrease of only 0.5 percent in comparison to March 2009. Submarket rental rates are as follows:

- North County: \$1,373, up 3.33 percent compared to March 2007
- South County: \$1,262, up 5.48 percent compared to March 2007
- Interstate 15 Corridor: \$1,382, up 2 percent compared to March 2007
- Highway 78 Corridor: \$1,162, up 7.5 percent compared to March 2007
- San Diego Central: \$1,418, up 4.1 percent compared to March 2007
- East County: \$1,101, up 3.5 percent compared to March 2007

Job growth is one of the leading factors contributing to San Diego's multifamily sector recovery. Beginning in 2007, many renters of all ages had doubled up or moved home in order to reduce living expenses. Now, as jobs are gradually added to the marketplace and renters feel more confident about their financial situation, this trend is declining and vacancy rates have stabilized countywide.

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San Diego County is the third largest employment center in California, employing 1.215 million workers in non-farm industries. San Diego's unemployment rate is 2.2 percent less than California as a whole as of April 2010. In addition, San Diego employment sectors added 3,700 jobs in February 2010 and Moody's forecast indicates a positive employment growth of 1.3 percent in 2011. Furthermore, job sectors forecast to lead the recovery in 2010 and 2011 in San Diego include educational and health services, professional and business services, and financial services.

Multifamily investors believe San Diego is positioned well to lead the market out of the current downturn and are looking to stabilize their current portfolio and add to it with quality product in quality areas within the county. While strong market fundamentals are driving more and more capital toward well-located multifamily properties in San Diego, there is a limited amount of distressed property or willing sellers. As a result, buyers have been more aggressive on pricing to win deals. Quality properties on the market are seeing intense bidding, thus driving prices up and cap rates down.

Transaction volume is off 88 percent from the peak of the market in 2007, according to Real Capital Analytics. However, a large amount of multifamily capital has been raised during the past few years, and San Diego remains one of the most desirable places to invest. REITs and equity funds have been the most aggressive and active buyers in 2010. Institutional owners and private local groups have been the most active sellers. Cheap debt availability from Fannie Mae and Freddie Mac has also fueled buyer aggression. Cap rates remain low due to inexpensive debt and limited supply. Average cap rates hover in the low 6 percent range, with larger, newer and well-located properties trading in the low 5 percent cap range or even into the high 4 percent range. Notable 2010 transactions include Arbor Village, a 112-unit complex in San Diego, that sold in May for \$12.1 million; Forest Glen Condominiums, an 88-unit property in Oceanside, purchased in May for \$9.7 million; Monarch at Scripps Ranch, a 194-unit complex in San Diego, that sold in March for \$46.2 million; Del Mar Ridge, a 180-unit property in Del Mar, purchased in January for \$44.8 million; and The Casa's, a 388-unit complex in San Diego, that sold in January for \$53 million.

— *Darcy Miramontes is a principal and multifamily investment specialist at Cassidy Turley BRE Commercial.*

## **Retail**

San Diego's retail sector is one of the bright spots in the city's commercial real estate market, again enjoying the second lowest vacancy rate out of the major metro areas, after San Francisco. Its 5.4 percent vacancy rate is expected to bump up slightly to 6 percent by year's end, comparing against a 10.6 percent rate nationally.

Major projects continue to be announced, and construction has begun on several new developments. New announcements include the kickoff of Shea Properties' downtown Mercado del Barrio, a \$58.6 million, 305,000-square-foot retail center anchored by Northgate Market, 92 affordable apartment units and roughly 60,000 square feet of specialty retail space.

New restaurant and nightlife tenants continue to open throughout downtown, including Bencotto and Red Velvet Wine Bar at local developer Jonathan Segal's "Q" mixed-use project. However, downtown activity has spread to uptown neighborhoods as well, with new food and beverage entrants, including Barrio Star and Bankers Hill Bar and Restaurant, and upcoming expansions by downtown's Café Chloe and Basic Urban Kitchen.

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In Mission Valley, Sudberry Properties looks to break ground in November on the first residential phase of its massive Civita project, formerly known as Quarry Falls. At build-out, the project will include approximately 4,800 residential units, anchored by more than 900,000 square feet of retail and office uses along Friars Road. Further out on the development timeline, Donahue Schriber's Del Mar Highlands Town Center and Terramar's Old Police Headquarters downtown are drawing interest from new retail and restaurant tenants, particularly from Los Angeles and Orange County.

For existing retail space, tight markets such as coastal north county, downtown and the park neighborhoods are once again seeing multiple offers on desirable spaces, particularly built-out restaurants in prominent locations. Gentrifying neighborhoods such as North Park, Mission Hills and Bankers Hill continue to evolve as restaurant and nightlife destinations for both the affluent local residents as well as patrons from as far as north county.

Other areas of activity include expanding specialty restaurant and QSR concepts from other markets looking to take advantage of San Diego's appealing demographics. Encouragingly, the multiple big box vacancies of past quarters have mostly been absorbed by new retailers, primarily discount and grocery tenants, including specialty ethnic markets.

Still to come are previously announced renovations and expansions at several of the area's largest regional malls, with Simon Property Group recently announcing that Fashion Valley mall will undergo a \$15 million renovation that will include an overhaul of the food court and landscaping upgrades. Work is scheduled to begin in July and will be completed by the end of September 2011. Other announcements are expected from Westfield Group on previously announced renovations at Horton Plaza Shopping Center and University Town Center.

Two major local retail centers have recently seen transactions impacting ownership, with Del Mar Plaza selling to a German fund for \$41.6 million (\$557.41 per square foot) and the financing for The Forum in Carlsbad being restructured by new investors and Thomas Enterprises, the original developer.

— *Jack Illes is a partner in the Urban Strategies practice group at Cassidy Turley BRE Commercial.*

## **Office**

The San Diego office market is showing exciting signs of improvement. At the end of first quarter 2010, San Diego had 485,382 square feet of positive absorption, and direct vacancy was at 16.9 percent, down from 17.4 percent at year-end 2009.

Fifteen of the 30 submarkets that make up San Diego County posted positive absorption. Central San Diego accounted for the majority of the absorption with 413,544 square feet being absorbed. The largest contributor was the Governor Park submarket with 155,875 square feet of absorption, as Mitchell International leased approximately 141,000 square feet of office space at Kilroy Governor Pointe and will be vacating approximately 80,000 square feet in Scripps Ranch. Del Mar also had a strong first quarter with 129,090 square feet of absorption as a result of Knobbe Martens' 72,291-square-foot lease at The Heights at Del Mar and Foley & Lardner's 40,004-square-foot lease at Kilroy Centre Del Mar. Knobbe Martens will relocate from downtown while Foley & Lardner will relocate from Torrey Hills.

The second quarter progressed with increased demand as tenants are seeking a "flight to quality." Relocating from a Class B facility, Nokia recently signed a lease for 200,000 square feet

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at the Summit Rancho Bernardo, which is a new Class A, LEED-certified office project. Palomar College is expanding and is now in escrow to purchase an 110,000-square-foot, newly constructed, Class A project with additional land in Rancho Bernardo. In addition, Bridgepoint Education is continuing to expand and has a lease out for signature in Kearny Mesa for 80,000 square feet.

While large users have been leasing up many of the sizable blocks of space throughout the county, demand for smaller tenants less than 10,000 square feet has started to increase as well. During 2009, the majority of tenants were opting for short-term extensions at their current facilities. Today, as rents have softened and the outlook on the economy has improved, tenants are finding that it is the ideal time to relocate to newer, higher-quality and better-located projects. In a majority of the submarkets, lease rates have declined anywhere from 20 to 30 percent in the past 2 years, making these more desirable projects more affordable for tenants.

Sales activity has increased significantly in 2010 as a result of buyer and seller expectations becoming more in line with one another. Two prominent office projects have traded in Mission Valley thus far: 1450 Frazee, which was purchased by Menlo Equities; and Mission City, Bldg. D, which was purchased by Kilroy Realty. However, several projects throughout the county are now on the market and will most likely be trading hands in the near-term, which suggests that there is plenty of money on the sidelines and investors are feeling more confident that the time is right to finally jump back into the market.

There are no new speculative office projects under construction or planned in the near-term, as today's rental rates and construction costs do not justify any new development. Many landlords are investing capital into their existing projects in order to upgrade their quality and become more competitive.

The outlook for the San Diego office market remains positive for a number of reasons, including its diverse economy, increasing tenant demand and expanding industries, which include healthcare, education, technology, biotech, and research and development.

— *Tony Russell is an office leasing specialist at Cassidy Turley BRE Commercial.*

## **Industrial**

After 5 consecutive quarters of significant negative absorption, the San Diego industrial market appears to be finding a bottom. Leading into 2010, the sector added more than 5.1 million square feet of vacant inventory from fourth quarter 2008 to fourth quarter 2009, averaging more than 1.02 million square feet of negative absorption for the past 5 quarters. However, 2010 started off noticeably different, with net absorption in first quarter 2010 only slightly negative and the overall vacancy remaining unchanged at 10.6 percent, a significant departure from the 5-quarter trend.

Several San Diego market trends bring reason for optimism. Aside from the halt in negative absorption, the industrial market is regaining a solid footing with the help of its diverse industry clusters, including defense, life science, communications and medical-device companies.

Recent transactions boosting the market include Life Technologies for 179,000 square feet, Isis Pharmaceuticals in a 175,000-square-foot build-to-suit, Genoptix in two transactions totaling 76,000 square feet and Outsource Manufacturing for 57,000 square feet, with large new requirements in the pipeline for companies such as Northrop Grumman, LG Electronics, Nuvasive and Kyocera.

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While these growth sectors are bringing stability back to the market, the large majority of industrial tenants are seeking lateral moves to comparably sized locations or structuring early renewals to take advantage of today's favorable lease rates and concessions. County-wide industrial asking rents have declined 12.5 percent in the last 12 months, with free rent and tenant-improvement concessions increasing in most submarkets during that period. Owner-user transaction volume is noticeably up in 2010, with markets such as Carlsbad seeing triple the deal velocity compared to 1 year ago. New construction remains at a standstill, with only one speculative building under construction in all of San Diego County.

The widely held expectation of a large supply of distressed property sales in 2010 has not been realized. Today's reality is that there are far more distressed property funds/buyers than there are assets, often resulting in a scarcity premium favoring the sellers. This is particularly the case for industrial product where the relatively low ongoing capital cost is attractive to investors considering today's stingy capital markets. Recent investment transactions in San Diego County include QueensCare's \$22.4 million purchases of a 128,706-square-foot building at 10132 Airway Rd. in San Diego; Newport National Corp.'s \$10.9 million buy of a 157,886-square-foot property at 5962-5966 La Place Court in Carlsbad; and EastGroup Properties \$17 million acquisition of a 274,266-square-foot facility at 1425 Corporate Center Dr. in San Diego.

San Diego's diverse economic base is widely expected to outperform most other California markets as the market transitions to recovery. The recent employment data from the California Employment Development Department is favorable, with the county unemployment rate dropping from 11 percent in March to 10.4 percent in April as 1,600 jobs were created. It was the fourth straight month that employers added jobs in both the state and the county, indicating that productivity may have been stretched to the limit, bringing demand for new jobs. The question remains though: will San Diego's diverse economy be able to sustain the positive trend as federal stimulus programs start to wind down in the next 12 months? The leading indicators point to yes, with an expectation for a trough in the market through late 2011, during which time the market is expected to end its precipitous decline of the last 15 months, stabilize lease rates and concessions, and build towards rent growth in 2012.

— *Dennis Visser is an industrial specialist at Cassidy Turley BRE Commercial.*