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As Economy Recovers, Office Construction Likely to Pick Up

REAL ESTATE: Financing Easier to Obtain; Optimism Rising Among Developers
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Capstone Advisors of Carlsbad recently purchased a 40,000-square-foot shopping center in Escondido for $3.9 million, and is scoping the market for similar properties as financing fundamentals continue to improve.

Its primary investment focus is retail real estate. But company President and Chief Executive Officer Alex Zikakis says Capstone will be monitoring improvements in the local jobs market in the coming months to decide on a potential return to the arena of office real estate, where it was active in the late 1990s.

“There’s definitely more transaction activity now than there was a year ago,” Zikakis said of the San Diego County office market, though sales have yet to return to pre-recession levels. “We’re going to be looking at more investments as the economy recovers.”

The latest commercial real estate survey, released in mid-July by the UCLA Anderson School of Management and Allen Matkins law firm, found developer and investor optimism increasing in major California markets with respect to office vacancies and rents. That trend would at least partly justify higher asset prices and signal future construction.

In the past 18 months, researchers say, Class A commercial real estate values in some California markets have increased to near 90 percent of their pre-recession peaks. However, the rise is not supported by current rental and occupancy rates, which remain flat in most markets, including San Diego County, continuing to hover around their recession lows.

Locally and elsewhere in California, new commercial construction remains at a relative standstill across most property categories. That could be changing if developer and investor confidence in the market continues to rise.

Precursor to Restart of Construction

“Optimism with respect to office and industrial market fundamentals in 2013 and 2014, which first appeared a year ago, is an important precursor to the restart of commercial construction,” said Jerry Nickelsburg, a senior economist with the UCLA Anderson school’s forecast center.

Researchers periodically compile the views of commercial developers regarding how markets will play out in three years, since that is the average decision window for the bulk of commercial projects. Following 18 months of pessimism, the survey has now tracked one year of optimism.

After polling a panel of California real estate professionals involved in office and industrial development, researchers project that the San Francisco and Silicon Valley office markets are the most likely to see construction recover first, with Los Angeles and San Diego not far behind.

Eli Gilbert, senior research analyst in the San Diego office of brokerage firm Jones Lange LaSalle, which was not involved in the UCLA study, says some of the increase in transactions is being spurred by more readily available financing now being offered to well-capitalized buyers, who are able to minimize the debt they take on when buying properties.

The office sector overall is not getting the same level of interest from investors as apartment properties, although Gilbert says trophy office properties that go on the market are getting multiple suitors.

Job Growth

Gilbert says San Diego County’s employment climate has been strong in the past year, adding more than 10,000 non-farm jobs, but office vacancy rates have not budged significantly. That’s likely because of the still high level of “shadow inventory” on the market — space not being used by office occupiers that has been placed on the market for potential use by other tenants on a sublease basis.

According to JLL, the county’s direct office vacancy rate at the end of the second quarter of 2011 was 16.4 percent, and the total vacancy rate, with subleasable space factored in, was 17.6 percent.

The direct vacancy rate is similar to the 2009 figure of 16.8 percent. Even companies that have added workers in recent months have not necessarily been filling more space, Gilbert says.

Until vacancies drop significantly, Gilbert says the demand for new office product will not likely be rising dramatically in the near term, and the current supply of prime Class A properties on the investment market is limited.

Currently, JLL notes, there aren’t any speculative office properties in the county’s development pipeline, although two build-to-suit projects are under way. One is in Kearny Mesa, set to open in 2012 and fully pre-leased to Bridgepoint Education. The other, in Rancho Bernardo, is nearly completed and pre-leased mostly to Broadcom Corp.