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COMMERCIAL REAL ESTATE UPDATE

Stephen Whalen

Alex Zikakis, founder and president of Carlsbad-based Capstone Advisors Inc., recently purchased a three-story office building on Ivanhoe in La Jolla for $10 million. The property, built in 1984 and renovated in 2012, is a shift in strategy for the 18-year-old company. Zikakis said the company is now examining office properties in areas that have limited land availability and other barriers to entry.

Properties of a Recovery

PROPERTY: Industrial, Office Demand Grow; Vacancy Rates Declining

■ BY LOU HIRSH

Capstone Advisors Inc. recently did something that's been relatively unusual for the Carlsbad-based investment firm during the past few years: it purchased an office building in La Jolla for $10 million.

For much of the post-recession period, founder and President **Alex Zikakis** said, most of the 18-year-old company's attention has been focused on older "value-add" retail properties — primarily in Southern California, Arizona and the Mid-Atlantic region — that it renovates and repositions after acquiring them at prices well below replacement cost.

But early 2014 conditions in the local market, buoyed by an improving economy and job-creation climate, have investors like Zikakis paying closer attention to office properties. The three-story La Jolla property on Ivanhoe Avenue, built in 1984 and renovated in 2012, was fully leased at the time Capstone bought it.

"We've been seeing some indications that it might be time to wade more into the office market," said Zikakis, noting that the firm is examining areas like La Jolla that have little new construction underway, along with limited land availability and other barriers to entry.

Continued Improvement in Q1

Experts said the first quarter generally saw continued improvement in San Diego County's office and industrial property fundamentals, with job growth fueling demand for expansion space among companies in numerous sectors. Speculative construction remains scarce for both industrial and office buildings, as vacancy rates continue to shrink.

One result is that property markets, especially in the industrial segment, are tilting in favor of landlords, as rents rise and building owners in several neighborhoods find themselves able to stay competitive without having to offer a lot of concessions to tenants — at least not at the level seen just a year or two ago.

The region's overall industrial vacancy dipped to a pre-recession low of 7.6 percent in the first quarter, brokerage company **Cassidy Turley** reported, noting that rising confidence among tenants has now generated 11 consecutive quarters of declining vacancy. A year ago, the countywide vacancy rate was 9.2 percent.

"Fifteen of the county's 25 industrial submarkets are showing marked improvement in vacancy," said **Bryce Aberg**, managing director in the San Diego office of Cassidy Turley. "While some areas are still sluggish, most are more stable than they have been in years."

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Since industrial rents are still about 15 percent below pre-recession levels — averaging 80 cents per square foot countywide in the first quarter — Aberg said there is potential for continued rent increases in coming months, with higher price growth rates in the tighter markets.

Bryce Aberg

Demand Is Rising

Aberg noted that demand in the past year has been rising among all industrial product types — including manufacturing, research and development, and warehouse facilities — fueled by increasing space requirements in industries such as craft beer brewing, defense technology and construction.

Ty Moffatt, senior vice president in the San Diego office of **Colliers International**, said the industrial trends are most pronounced in the central markets that line Interstates 15 and 805. That includes high-demand places like Kearny Mesa, Miramar, Mira Mesa and Sorrento Mesa, where landlords are in the most advantageous position because of limited available space.

Ty Moffatt

Other markets — including South County and portions of North County — are seeing slower recovery but could benefit in coming months as companies seek spaces after being shut out of the central neighborhoods, Moffatt said.

Cassidy Turley noted that there were just two industrial projects under construction in the first quarter: a 156,421-square-foot build-to-suit project in Vista, which is 72 percent preleased to **Applied Membranes** and set for completion in the second quarter; and a 115,000-square-foot project in Poway that is fully preleased to **General Atomics Aeronautical Systems Inc.**, which plans an August 2014 move-in.

In the office market, Colliers reported that the countywide vacancy rate went below 14 percent for the second consecutive quarter, and rental rates rose for the ninth consecutive quarter.

Robust Recovery in Class A

One caveat, Colliers Associate Vice President **Derek Applbaum** said, is that the Class A segment is enjoying a more robust recovery than the overall office market. While Class A rents rose about 9 cents per square foot or 4 percent in the latest quarter, the overall increase for the county was 5 cents per square foot, or 3 percent.

Derek Applbaum

Performance numbers continue to vary widely based on the supply-and-demand variables of individual office neighborhoods.

Local average asking rents in the first quarter ranged from $1.73 per square foot in Vista and $1.76 in Oceanside, to $3.12 in University Towne Center and $3.56 in Del Mar Heights, according to brokerage company **JLL**. The countywide average was $2.24 per square foot

JLL reported that local leasing activity saw an increase at the end of 2013, but tapered off in the early months of 2014. However, growth in office space demand in sectors like technology and life sciences is expected to bring rising rents and occupancy rates across the region in the coming year, the brokerage company said.

In most neighborhoods, owners of existing office buildings still have little to fear from new product coming on the market. Local brokers note that the only major speculative office construction underway at the end of the first quarter was **Irvine Co.**'s La Jolla Centre III, a 15-story building in UTC set for completion in 2015.

San Diego Office Statistics Q1 2014

Total by Class

Class	Total Inventory	Direct vacancy (square feet)	Direct vacancy	Total vacancy (square feet)	Total vacancy	Average asking rent (per square foot)	Under construction (square feet)
Class A	26,834,574	3,064,498	11.4%	3,425,684	12.8%	$2.81	1,040,575
Class B	39,488,895	6,448,294	16.3%	6,728,351	17.0%	$2.11	54,884
Class C	12,462,266	1,304,573	10.5%	1,318,550	10.6%	$1.55	0
Totals	78,785,735	10,817,365	13.7%	11,472,585	14.6%	$2.24	1,095,459

Source: JLL

San Diego Industrial Market Statistics

The San Diego industrial market has a strong mix of high tech, biotech, defense and aerospace companies, as well as traditional manufacturing tenants.

County	Building Sauare Feet	Overall vacancy	Availability	Current net absorption (square feet)	Current gross activity (square feet)	Under construction (square feet)	Construction deliveries (square feet)	Average asking lease rate
South County	31,164,942	9.2%	16.0%	176,561	562,180	-	-	$0.51
East County	16,816,734	3.4%	7.7%	14,661	171,864	-	-	$0.66
Central County	78,865,626	7.3%	11.2%	554,046	1,756,584	365,000	-	$1.38
North County	51,246,154	8.2%	10.9%	318,223	987,010	-	156,421	$0.74
SW Riverside County	14,589,592	6.4%	9.2%	180,034	319,390	-	-	$0.51
San Diego Totals	192,683,048	7.4%	11.5%	1,243,525	3,797,028	365,000	156,421	$0.94

Source: CBRE Research and CBRE Econometric Advisors Q1 2014