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Investors Get More Competitive in San Diego Institutions, private owners continue looking for opportunities in a healthy economy

By Mandy Jackson CREJ Staff Writer

The tide is turning in the San Diego County office market as a new wave of investors compete with other long-term owners in the region.

When **PricewaterhouseCoopers** and the **Urban Land Institute** named San Diego the top investment market for 2006 in Emerging Trends in Real Estate, the report confirmed the fondness a growing number of institutional investors have for the market.

Low unemployment, a diverse economy, steady population growth and limited new office development adds up to a good climate for the local economy and property owners.

According to **CB Richard Ellis**, San Diego County office vacancy fell from 9.6 percent in third quarter 2005 to 8.9 percent in fourth quarter 2005. Rents increased to $2.20 per square foot per month from $2.13 three months earlier. Fourth-quarter net absorption was 533,000 square feet, bringing the year's total to 1.8 million square feet.

"We've been interested in San Diego for quite a while," said Paul Twardowski, lead manager in San Diego for Houston-based **Hines**.

While Hines served as development manager for Petco Park, the downtown San Diego baseball stadium that opened in 2004, the private investment firm was looking at potential acquisitions and development opportunities.

"But we were never able to get that done until 2005 when we had some capital with matching interest," Twardowski said.

The privately held real estate investment firm announced in January that it acquired 3 acres entitled for up to 450,000 square feet within the 12-acre La Jolla Commons site in University City. Hines plans to begin construction of a high-rise tower in fourth quarter 2006 and complete the project in first quarter 2008.

In October, Hines and the **California Public Employees Retirement System** purchased the three-building, 220,000-square-foot Pacific Plaza office complex in the Torrey Hills area. Hines and a subsidiary of **Sumitomo Life Insurance Co.** of Japan bought the 22-story, 423,546-square-foot Golden Eagle Plaza in downtown San Diego in August.

"Most of the trophy buildings in San Diego have sold and they sold with low cap rates," said Dan Gaston, an associate in the Carlsbad office of **Lee & Associates**. "Investors felt San Diego still had the potential for increasing rental rates; some areas had 20 percent increases in rental rates."

Demand for owner-user purchases continues, but pricing may be getting to the point where some businesses are evaluating owning versus leasing.

Investment Fundamentals

For investors, Gaston said there continues to be more demand for property than there are good assets to purchase. Many buyers are looking for other opportunities.

"Rental rates are still creeping north, and as long as that is happening guys will look at buildings and think they can make some cosmetic changes and push rents up," Gaston said.

Portland, Ore.-based Harsch Investment Properties owns 286,000 square feet of office space in five suburban San Diego County properties. In 2005, Harsch paid $24.1 million for the 112,378-square-foot Avenue of Science Center in Carmel Mountain Ranch.

"We have lots of tenants that have gobbled up our vacant space," said Bill Rodewald, vice president and regional director for Harsch in San Diego. "They'll take the space before we have a chance to market it to outside tenants. In our office product, we're 98.7 percent occupied."

While private firms are still very active investors, San Diego County has seen an influx of institutional capital during the past year or more, Twardowski said.

"There's a shift from a local-eveloper, local-owner market to large-scale institutional owners. In terms of long-term stability of the market, it will help," he said. "Those groups tend to be very strategic about their ownership. They have a strategy and the wherewithal to hold their ground if there's stormy weather."

Pricing in San Diego County has been pushed to new highs during the past few years with capitalization rates falling to new lows as investors anticipate rising rents.

According to research from San Diego-based Grubb & Ellis|BRE Commercial and Bethesda, Md.-based CoStar Group Inc., capitalization rates began to level off in 2005, hitting 6.9 percent, down only 30 basis points from the previous year after a 170 basis point drop from 8.9 percent in 2003 to 7.2 percent in 2004.

"While we don't like the way prices have gone up so fast, it's not as dramatic for someone who has a long-term hold like we do," Rodewald said. "It's hard for someone that needs to turn a building around fast and give returns to investors."

For institutional investors considering San Diego, prices are not as high as in other U.S. markets where they want to place capital.

"If they are looking at properties in New York, San Francisco and Washington, D.C., then they look at San Diego where they don't have as much of a surprise in terms of pricing per square foot. It's more of a surprise to an investor that's been in San Diego for a long time," Twardowski said.

Chicago-based **Trizec Properties Inc.** is deploying a lot of capital in Southern California in 2006. The real estate investment trust announced in late December that it will spend $1.6 billion to acquire key assets totaling 4 million square feet from Los Angeles-based **Arden Realty Inc.**, which is being purchased by **GE Real Estate** in a $4.8 billion transaction scheduled to close by the end of the first quarter.

Through the transaction with Arden, Trizec will enter San Diego with 1.3 million square feet of office space in three properties - 701 B Street and 707 Broadway in downtown and Arden Towers at Sorrento in Sorrento Mesa.

"We're fortunate to peel off what we feel are the best assets in the portfolio," said Patrick Lacey, vice president and general manager in Los Angeles overseeing Trizec's Southern California region.

"Vacancy is on the decrease, rental rates are on the increase and employment numbers continue to improve. We look at it, from the basic fundamentals of real estate, as very encouraging," Lacey added. "We're buying a portfolio in San Diego and Los Angeles that's 91 percent leased, with some rollover that we welcome because we know there's going to be growth in the market."

However, Lacey said he doesn't see institutional investors gaining a major presence in any particular San Diego submarket because there are essentially no owners selling large portfolios. Instead, institutions have to pick off the plum assets one at a time.

New Development

While developers are building new office product across the county, investors said it is not enough to have a significant impact on the market.

"We love the fact that in this cycle, unlike some of the cycles I've seen in the past, people are not overbuilding," Rodewald said. "There hasn't been extreme speculative development."

More than 1.25 million square feet of new office space was completed in 2005, according to Grubb & Ellis/BRE, and 2.3 million square feet of additional space was under construction at year's end. The brokerage anticipates that new buildings will put upward pressure on rents because of high construction costs.

"I think 2006 is going to remain pretty stable. There's not a lot [of new product] coming on the market right now," Gaston said. "We're seeing rental rates increase. Space is becoming harder to find. There are less concessions - if any are given - on leasing."

Even in Carlsbad where office and industrial developers have bought hundreds of acres during the past few years, construction still is not outpacing demand, according to Gaston. He said only 275,000 square feet will open in the North County city this year.

"Bressi Ranch has a couple million square feet planned, but the things that are going to hit the market in 2006 are not enough to affect the general direction of rental rates," Gaston said. "A lot of these projects are 18 to 24 months away from being able to deliver."

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