

San Diego Industrial Market a Mix of Highs and Lows

San Diego County's industrial market represents the highs and lows of the commercial real estate cycle.

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A low overall vacancy rate led to new construction in submarkets where there is still land for development, pushing vacancies into the double digits at the north and south ends of the county when absorption slowed, while single-digit figures held firm in the central, land-constrained submarkets. All the ups and downs, coupled with constraints in the capital markets, have investors sitting on the sidelines until things level out.

"Each submarket and each property type stands on its own right now," said Rob Merkin, senior vice president at CB Richard Ellis in San Diego.

For the most part, the central San Diego submarkets, including Mira Mesa, Kearny Mesa, Sorrento Mesa and the Interstate 15 corridor, are performing well, though Rancho Bernardo and Scripps Ranch on I-15 have double-digit vacancy.

"Sorrento Mesa is doing better than any year since 2000, when we were at the height of hyper-activity in the [high-tech] market," Merkin said. "Kearny Mesa is down in absorption, but that's because there's nothing available. The vacancy is at 2.4 percent, which is staggering for our largest industrial submarket."

Industrial vacancy in San Diego County increased from 6.5 percent in 2006 to 7.2 percent at the end of last year, according to CB Richard Ellis. The highest vacancy rates were 16.1 percent in South County's Otay Mesa and 15.4 percent and 11.8 percent in the North County cities of Oceanside and Carlsbad.

However, most San Diego submarkets had single-digit vacancy rates, with the lowest numbers in Rose Canyon/Morena at 1.6 percent, Airport/Sports Arena at 1.8 percent and Escondido in the North County at 2 percent.

Among industrial property types, Merkin said light industrial assets are seeing some of the highest vacancies in San Diego. Negative net absorption was recorded last year for corporate headquarters, research-and-development and manufacturing facilities. Absorption was positive or at least stable for multitenant research-and-development, multitenant industrial, distribution and warehouse buildings.

Rent Growth

Despite negative results in many industrial property types, all segments saw average rents increase last year. San Diego County industrial rents increased 30 percent from 2004 to 2007, peaking at an overall asking lease rate of \$1.10 per square foot per month in the first quarter of last year, according to CB Richard Ellis. Rents flattened for the rest of 2007 as vacancies increased and absorption slowed.

"We think that rental rates are going to stay flat for the next 18 months and we think vacancies are going to increase slightly, but it will be nothing dramatic," said Mickey Morera, an industrial specialist at Cushman & Wakefield in San Diego.

Cushman & Wakefield pegged year-end vacancy for 2007 at 7.5 percent.

"Vacancy is going to be going up a little bit, but there's still going to be single-digit vacancy and competition for good spaces," Morera said.

Much of the increasing vacancy can be attributed to the housing market slowdown as construction companies and housing-related retailers, including furniture stores, give back warehouse space.

"Leasing activity is still good," Morera said. "Transportation companies are still aggressively looking for

space. Health care providers, hospitals, hospital suppliers and other health care industries are looking for space along with the county, state and federal government."

Also, defense contractors continue to take down empty warehouse buildings and convert them to manufacturing and research-and-development space.

"The industrial market in San Diego has always been strong, the one exception being South Bay because of the amount of affordable land down there; it tends to get ahead of itself with new construction," said Randy LaChance, senior vice president in the San Diego office of Voit Commercial Brokerage.

"We may see a slight tick up in vacancy, but when you're only 5.9 percent vacant it is still a very healthy market," LaChance said.

Voit reported San Diego County industrial vacancy of 5.92 percent in its fourth-quarter 2007 report, up slightly from 5.75 percent a year earlier. The brokerage reports data for the research-and-development market separately from its industrial figures. Research-and-development vacancy was 11.61 percent at the end of 2008, up from 10.7 percent a year earlier.

Industrial properties saw 1.4 million square feet of net absorption in 2007, nearly half of the 2.7 million square feet recorded in 2006 and lower than the 2 million square feet absorbed in 2005, according to Voit. The R&D market saw negative 133,489 square feet of absorption in 2007, compared with 957,166 square feet of absorption in 2006 and 1.4 million square feet of space in 2005.

Mixed Views on Leasing

Based on the assets owned or managed by Newport Beach-based Master Development Corp. in San Diego County, Charles "CJ" Stos, development manager for the company, said there is a decent amount of leasing activity for industrial assets in the region.

Stos said there are a few companies looking for 150,000 square feet or more to occupy by the end of 2008 and there are at least 10 users looking for 70,000 square feet or more.

"When you look at available buildings in that size range, that's a pretty solid number," he said. "There's not a lot of existing assets in the 150,000-plus range, especially in the middle of the county."

However, Stos noted that there are several large buildings in the South County submarket of Otay Mesa from a lot of recently completed projects, such as San Diego-based Sudberry Properties Inc.'s six-building, 661,300-square-foot Ocean View Hills Corporate Center, which is largely vacant.

Master Development built Three Piper Ranch, a two-building, 333,000-square-foot project in Otay Mesa, in which one 155,000-square-foot structure was leased to Imperial Toy Co. and the other 178,000-square-foot facility is vacant. Both buildings are now owned by New York-based BlackRock Inc., an investment management firm.

But in the North County, where vacancies are also in the double digits and rising in Carlsbad and Oceanside, Howard Schwimmer, co-founder and managing partner at **Rexford Industrial**, said the company is frustrated by the leasing activity it is seeing.

Rexford owns 5 million square feet throughout Southern California and Schwimmer said the weakest industrial market in the company's portfolio is San Diego County, where the company owns 1 million square feet, mainly in the North County submarkets.

He said Carlsbad "has become a little bit of a bloodbath," because there is a plethora of new construction, from large warehouses to research-and-development and small buildings for sale, and there are not enough tenants or owner-users to absorb the space.

"We have hardly anyone looking at this product," Schwimmer said. "Showings are few and far between and it seems like the decision-makers aren't really interested in making decisions. It's actually really frustrating."

People are just anxious about the overall economy, so if they don't have to make a decision right away then they are putting off plans to move or take more space.

"The land-constrained markets in the central area and South County properties just south of downtown are doing just fine," Schwimmer said. "In the North County, you can go there and it's not unusual to find buildings that have been empty for years."

Owner-User Market

Something that Rexford is seeing a lot in San Diego County right now that it's not seeing in any other area of Southern California is broken industrial condominium conversions, where developers purchased large industrial buildings to convert into condominiums, but they are no longer able to sell the units to owner-users.

Like Rexford, Master Development has been approached by multiple investors looking to sell unfinished projects with industrial condominiums or small buildings for sale that target owner-users.

At Britannia Crossings in Otay Mesa, Master Development built its own industrial condominium project, but just one unit remains unsold.

"There's definitely a slow down in the owner-user market," Stos said. "The demand for for-sale product, for smaller buildings of 15,000 square feet and less has slowed."

He said it is more difficult for small businesses to get financing, despite favorable interest rates, because banks are scrutinizing loans more closely in light of subprime residential mortgage problems and the resulting credit crunch. Also, with home sales and prices down, business owners are more reluctant to invest because they don't have as much equity to pull out of their homes and invest in industrial condominiums.

Dennis Visser of Grubb & Ellis|BRE Commercial in San Diego agreed that the owner-user market has been impacted by the housing downturn, as well as concerns for the economy, but he said more favorable financing due to lower interest rates began to help that segment of the investment market in January.

"The industrial market has reacted quickly to some bad signals in the market," Visser said. "Construction is a good barometer. Right now, there is about 1.2 million square feet under construction in the county, but we were averaging about 3 million square feet a year from 2004 to 2006."

Of the 1.2 million square feet of industrial space under construction at the end of 2007, 47 percent was in Otay Mesa, where 572,505 square feet were under way, according to Grubb & Ellis|BRE. Another 11 percent was in San Marcos, 8 percent was in Carlsbad, 7 percent was in Rancho Bernardo, 6 percent was in Oceanside and the last 21 percent was in the county's 20 other submarkets.

While Otay Mesa had a lot of construction under way last year, it also had the highest net absorption of any industrial submarket in the county by a factor of almost two, according to Linda Greenberg, senior vice president at Colliers International in San Diego.

According to Colliers' fourth-quarter report, Otay Mesa saw net absorption of 675,399 square feet in 2007, with Oceanside at the North end of the county reporting the second-highest level of absorption at 366,438 square feet.

Otay Mesa has seen positive absorption this year as well with Circle Foods LLC leasing a 159,631-square-foot build-to-suit facility in San Diego-based Murphy Development Co.'s Siempre Viva Business Park.

"Even with 2.4 million square feet vacant, there are still users that need build-to-suits because the product they are looking for doesn't exist in the market," Greenberg said. "Circle Foods is a food processor and it's expensive to retrofit for that."

Other special-purpose facilities have been planned recently in Otay Mesa for Cantare Foods Inc., which bought land and built a 72,000-square-foot food processing facility last year, and San Diego PreCast Concrete, which executed an 83,000-square-foot build-to-suit agreement.

"I think since January we've seen an increase in activity in North County and my hope is that people will start taking down some of the space and we'll see more people making decisions," said Schwimmer of Rexford Industrial.

Investment Activity

The company would love to sell some of its empty buildings in the North County and it has several buildings on the market, he said, but potential buyers have offered prices so low it doesn't make sense to sell it.

"We're very interested in buying, but right now it's virtually impossible for us to underwrite deals in the North County," Schwimmer said. "We would like to get some things in central San Diego, [but] there's just not that much product that changes hands."

Visser said transaction volume has dropped significantly since third-quarter 2007 and there are not a lot of industrial properties on the market.

According to New York-based Real Capital Analytics, investors paid \$1.49 million for San Diego County industrial assets in 2007, up slightly from \$1.39 million in 2006. However, sales activity took a steep dive last year from \$656 million in the third quarter to \$105 million in the fourth quarter.

"The investment side of the market is a little slower," Visser said. "The capital markets have changed and there's still some correction in pricing that needs to be made. We're seeing a gap still between buyers and sellers in that area."

If sellers can't find the right buyer at the right price, they're holding on and being patient. Buyers are being patient too, waiting for prices to adjust lower.

Morera of Cushman & Wakefield said pricing has started to come down, with industrial capitalization rates on some properties down 50 to 100 basis points from similar transactions a year ago. However, he said

there are some 1031 exchange buyers, private equity investors, foreign funds and Middle Eastern groups aggressively looking to buy industrial property.

"In 2008, there will be some good opportunities to buy real estate, especially for developers or investors who have the cash today," said Stos of Master Development.

Developers or investors dependent on financing from a lender will have a harder time competing. Master Development has made offers on transactions recently where it was outbid, but the investors or developers with the higher bids were unable to get financing, so the sellers or their brokers are coming back to Master Development.

Master Development has a discretionary fund with GE Capital, which allows the developer to close on all-cash acquisitions in just 30 days for the right deal. Right now, Stos said the company is looking for land or existing buildings with a value-add component in San Diego.

"In 2008, I'd like to see us buy two or three buildings - from \$7 million to \$35 million is our bread and butter," he said. "I want to concentrate on us executing our business plan for our existing properties. I want to stay focused on what we know, what our business plan is, which is industrial."

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